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Eric J. Gouvin

Western New England University School of Law, egouvin@law.wne.edu

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Articles

Resolving the Subsidiary Director's Dilemma

by

ERIC J. GOUVIN*

Introduction

Holding companies dominate our economy.¹ In 1995, the ten largest companies on the Fortune 500 owned an average of 62 subsidiaries each.² Many subsidiary corporations, though owned entirely by

* Associate Professor of Law, Western New England College School of Law. B.A. 1983, Cornell University; J.D. 1986, LL.M. 1990, Boston University School of Law. I thank Jim Gardner, Don Korobkin, Elizabeth Lovejoy, Jay Mootz, and Bob Titus for their comments on earlier drafts of this article.

1. In this article, the term "holding company" refers to the common situation where a typically nonoperating parent corporation owns a number of operating subsidiaries. This form of ownership plays a huge role in the U.S. and world economies. The vast majority of the banking, insurance, transportation, communications, and securities firms in the U.S. economy are subsidiaries of holding companies. MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION* 277-81 (1976). The most famous examples of the holding company form of ownership are the multinational conglomerates formed in the 1960s such as L.T.V., Gulf & Western, and others. *See id.* at 282; *see also* BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* 58-65 (1990) (presenting a straightforward discussion of how the conglomeration device works from a financial point of view).

2. This figure reflects corporate affiliates identified as "subsidiaries" or "non-U.S. holdings" in the database. DIALOG, File No. 513 (Oct. 28, 1995) (searching Field "HR," or "Corporate Family Hierarchy"). The subsidiary figures for the *Fortune* top ten are: General Motors, 91 subsidiaries; Ford Motor Company, 183 subsidiaries; Exxon, 44 subsidiaries; Wal-Mart Stores, 1 subsidiary; AT&T, 17 subsidiaries; General Electric, 72 subsidiaries; International Business Machines, 76 subsidiaries; Mobil Oil Corp., 55 subsidiaries; Sears Roebuck and Company, 4 subsidiaries; and Philip Morris, 80 subsidiaries. These figures may be somewhat inflated in that they include subsidiaries of subsidiaries in the calculation. Looking only at subsidiaries whose immediate parent is one of the *Fortune* ten, the average number of subsidiaries drops to 34.3 per corporation. Drawing on data compiled in 1982, Phillip Blumberg noted that each of the 1000 largest U.S. industrial corporations on average controlled 48 subsidiaries. PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: SUBSTANTIVE LAW* xxxiii (1987) [hereinafter BLUMBERG, *SUBSTANTIVE LAW*]; PHILLIP I. BLUMBERG, *THE LAW OF CORPORATE GROUPS: PROCEDURAL LAW* 463-74 (1983) [hereinafter BLUMBERG, *PROCEDURAL LAW*].

another corporation, are themselves gigantic corporate enterprises. For example, Philip Morris, the tenth largest U.S. corporation,³ owns such major businesses as the Miller Brewing Company, Kraft Foods, and the Philip Morris tobacco manufacturing operating unit.

Although subsidiaries play a significant role in our economy,⁴ surprisingly little has been written about the duties of their directors.⁵ Despite widespread acceptance of holding companies as commonplace business entities, several legal problems inherent in the holding company form of ownership remain unresolved. Holding companies raise legal dilemmas for subsidiary directors that are easier to ignore than to resolve.

Like all corporate directors, the directors of subsidiaries are bound by fiduciary duties. However, as Justice Frankfurter observed

3. In its 1995 annual survey of the 500 largest U.S. corporations, *Fortune* magazine identified the following as the ten largest: (1) General Motors, (2) Ford Motor Company, (3) Exxon, (4) Wal-Mart Stores, (5) AT&T, (6) General Electric, (7) International Business Machines, (8) Mobil Oil Corporation, (9) Sears Roebuck and Company, and (10) Philip Morris. *The Fortune 500 Largest U.S. Corporations*, FORTUNE, May 15, 1995, at F-1.

4. For a discussion of the huge role that subsidiaries play in world commerce, see BLUMBERG, SUBSTANTIVE LAW, *supra* note 2, at xxxii-xxxiii.

5. Since the 1920s and 1930s, little scholarly effort has been expended on the troublesome relationship between parent and subsidiary. The one modern example of exhaustive scholarly effort on the subject of parent and subsidiary corporations is the multivolume treatise PHILLIP I. BLUMBERG & KURT A. STRASSER, *THE LAW OF CORPORATE GROUPS* (1992). That comprehensive work provides a thorough treatment of enterprise liability, although it does not explicitly address the issues raised in this Article. Other than Blumberg, commentary is scarce. What little has been written consists primarily of student notes focusing on the problems of self-dealing when a subsidiary is not wholly owned. See, e.g., Michael B. Goldberg, Note, *The Fiduciary Duty of Parent to Subsidiary Corporation*, 57 VA. L. REV. 1223 (1971); Robert D. Kodak, Comment, *The Corporate Fiduciary Duty Doctrine and the Requirement of Fairness in Parent-Subsidiary Relations*, 76 DICK. L. REV. 237 (1972); Steven F. Mones, Comment, *Protection of Minority Shareholders in Parent-Subsidiary Tender Offers: Joseph v. Shell Oil Co.*, 9 DEL. J. CORP. L. 729 (1984); Thomas W. Wälde, *Parent-Subsidiary Relations in the Integrated Corporate System: A Comparison of American and German Law*, 9 J. INT'L L. & ECON. 455 (1974); Note, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, 74 YALE L.J. 338 (1964). Cf. Zenichi Shishido, *Conflicts of Interest and Fiduciary Duties in the Operation of a Joint Venture*, 39 HASTINGS L.J. 63 (1987). Other than articles dealing with the questions of when to pierce the corporate veil of the subsidiary to hold the parent liable for torts and contracts of the subsidiary, see, e.g., J.A. Bryant, Jr., Annotation, *Liability of Corporation for Contracts of Subsidiary*, 38 A.L.R.3d 1102 (1971), and R.A. Horton, Annotation, *Liability of Corporation for Torts of Subsidiary*, 7 A.L.R.3d 1343 (1966), the scholarly effort has focused on the economic efficiency of the subsidiary device, see RICHARD POSNER, *ECONOMIC ANALYSIS OF THE LAW* 379-82 (3d ed. 1986); Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 110-11 (1985); Richard Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499, 509 (1976) [hereinafter Posner, *The Rights of Creditors*]; and Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 FORDHAM L. REV. 227 (1990).

more than fifty years ago, "to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry."⁶ In the context of the parent-subsidiary relationship, a necessary inquiry is: To whom does the subsidiary director owe the fiduciary duty? That simple question defies a simple answer; it is not always clear to whom subsidiary directors owe their fiduciary duty.⁷ Case law leaves subsidiary directors wondering whether their duty runs primarily to the parent corporation as shareholder, to the subsidiary corporation itself as an entity, or even to other constituencies such as creditors, regulators, employees, and communities.⁸

In most situations confronting subsidiary directors, the quandary of figuring out who is the recipient of the fiduciary duty is of mere academic interest. In the ordinary situation, one would assume that the interests of the subsidiary corporation as an entity and the interests of the parent corporation as shareholder coincide, thereby making further inquiry into the subsidiary director's fiduciary duty uninteresting, if not altogether moot. Despite the strong intuitive appeal of that typical scenario, however, in many cases the interests of the wholly owned subsidiary as a corporate entity do not coincide with the interests of the parent corporation as shareholder.⁹

In many situations, the board of directors of the subsidiary corporation is not free to take action that is in the best interests of the sub-

6. SEC v. Chenery Corp., 318 U.S. 80, 85-86 (1943).

7. Even the American Law Institute has trouble determining to whom corporate directors owe their fiduciary duty. The drafters of the Principles of Corporate Governance changed the term "duty of loyalty" to "duty of fair dealing" precisely because determining the beneficiary of the duty of loyalty is so fraught with uncertainty. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, Part V, introductory note a, at 264 (Proposed Draft, Mar. 31, 1992) [hereinafter A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE].

8. The current confusion in the law of subsidiary corporations is not a recent development. Corporate law relating to subsidiaries has always been unclear. Professor Ballantine may have said it best when he observed more than 70 years ago that the doctrine of subsidiary corporations is a "legal quagmire." Henry W. Ballantine, *Separate Entity of Parent and Subsidiary Corporations*, 14 CAL. L. REV. 12, 15 (1925). Justice Cardozo was a little more charitable in a famous quotation where he referred to the doctrine of parent and subsidiary corporations as being "enveloped in the mists of metaphor." *Berkey v. Third Avenue Ry.*, 155 N.E. 58, 61 (1926).

9. A recent case in which a holding company "looted" its subsidiary insurance company, allegedly to prop up the failing activities of its other subsidiaries, illustrates the point. See John H. Kennedy, *Monarch Life Sues Law Firm of Ex-Parent*, BOSTON GLOBE, May 7, 1993, at 57. A Massachusetts Supreme Judicial Court Justice referred to the relationship between the parent corporation and its subsidiary as "corporate child abuse." Christopher Geehern, *Suit Details Collapse of Monarch*, SPRINGFIELD (MASS.) SUNDAY REPUBLICAN, May 9, 1993, at D-1.

sidiary as a corporation, but instead must do as the parent corporation demands. For example, it is not unusual for subsidiaries to sell their products at reduced prices to their parents, to buy goods and services from their parents at inflated prices, to pay excessive management fees to their parents, to declare excessive dividends, or to otherwise to engage in transactions at the request of their parents that the subsidiaries never would have undertaken on their own.¹⁰ Therefore, the boards of subsidiaries often engage in activities that serve only the interests of the parent—even when corporate law imposes a duty on the directors to act in the interests of other parties.¹¹

The split between the parent's interests and the interests of the subsidiary can be especially pronounced when the subsidiary is a participant in a highly regulated industry. Often the directors of the regulated subsidiary will find themselves torn between a desire to make decisions in the best interest of the subsidiary as an independent corporation consistent with the larger regulatory scheme, and a countervailing desire to make decisions in accordance with the wishes of the parent corporation.¹² Although these types of conflicts arise in a number of situations, the following hypothetical from the banking industry illustrates the subsidiary director's dilemma: *X* serves as a director for *M* Bank, a commercial bank chartered by the Commonwealth of Massachusetts. *M* Bank, in turn, is a wholly owned subsidiary of Bank Holdings Company (BHC), a business corporation. BHC requires that *M* Bank purchase all of its data processing services from another wholly owned subsidiary of BHC even though independent vendors offer the same services at a lower price. BHC also requires *M* Bank to pay monthly "management fees" to BHC, even though BHC provides few, if any, valuable services. Finally, BHC also owns LeaseCo, a leasing firm that has run into serious financial difficulties as a result of an economic downturn. The funds LeaseCo has attracted from outside investors have been lost and LeaseCo is on the

10. Cf. Kieran J. Fallon, Note, *Source of Strength or Source of Weakness?: A Critique of the "Source-of-Strength" Doctrine in Banking Reform*, 66 N.Y.U. L. REV. 1344, 1383 (1991) (illustrating various methods by which parent corporations take advantage of subsidiaries).

11. See *infra* notes 38-54, 82-96, and accompanying text.

12. In the interest of full disclosure, see Ronald K.L. Collins, *A Letter on Scholarly Ethics*, 45 J. LEGAL EDUC. 139 (1995), I should state for the record that in 1989 and 1990 I represented a bank holding company against a wholly owned bank subsidiary in a situation where the board of the subsidiary insisted that it was required to make decisions solely in the best interest of the subsidiary, while the holding company insisted that the subsidiary approve various transactions designed to help bail out the holding company. In the intervening years I have come to appreciate the subsidiary board's position.

verge of bankruptcy. BHC, the common shareholder of both LeaseCo and M Bank, would be severely harmed by LeaseCo's economic collapse. To shore up LeaseCo, BHC requests that M Bank lend money to LeaseCo and issue a series of letters of credit in support of LeaseCo deals.¹³

The dealings with BHC and LeaseCo strike Director X as inadvisable. If M Bank were an independent company, Director X would not approve the transactions. Nevertheless, X knows that she owes a fiduciary duty to the shareholder, BHC. Recognizing this duty to the shareholder, Director X votes for the requested transactions even though she believes they are not in the best interests of M Bank as a corporate entity.

Under current law, director X may discover that giving the shareholder parent's desires priority over the corporate well-being of the subsidiary can give rise to director liability. In the litigation that followed the wave of bank failures in the late 1980s and early 1990s, many directors faced personal liability for bank losses. Although they had made decisions in the best interest of their sole shareholder, the directors often found themselves the target of lawsuits instituted by nonshareholder constituents involved in the corporate enterprise, including the banking regulators,¹⁴ customers,¹⁵ and other parties.¹⁶

13. Assume for the sake of argument that the size of these transactions do not violate the prohibitions of §§ 23A or 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c to 371c-1 (1994), but that the quality of the collateral may or may not meet the requirements of those sections.

14. Subsidiary directors of banks may be subject to suit from the bank regulators on a number of grounds, including cease and desist orders, 12 U.S.C. § 1818(b) (1994) (permanent orders), § 1818(c) (1994) (temporary orders); imposition of civil money penalties, 12 U.S.C. § 1818(i)(2) (1994); removal or suspension, 12 U.S.C. § 1818(e) (1994); or any act of gross negligence or other culpable conduct, 12 U.S.C. § 1821(k) (1994). For a general discussion of director liability from regulation, see Norma Hildenbrand, *D&O Liability: Expansion Via Regulation*, 111 BANKING L.J. 365 (1994); Heidi Mandanis Schooner, *Fiduciary Duties' Demanding Cousin: Bank Director Liability for Unsafe or Unsound Banking Practices*, 63 GEO. WASH. L. REV. 175 (1995). In addition to these statutorily created powers, some federal banking regulators have insisted that banks and their affiliated parties owe a fiduciary duty to the federal deposit insurance agency. See Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 LAW & CONTEMP. PROBS. 7, 15-31 (1993).

15. Directors may be subject to suits from depositors, *Hoehn v. Crews*, 144 F.2d 665 (10th Cir. 1944), *aff'd sub. nom. Garber v. Crews*, 324 U.S. 200 (1945); *Commercial Cotton Co. v. United Cal. Bank*, 209 Cal. Rptr. 551, 554 (Ct. App. 1985) (finding that bank has "at least [a] quasi-fiduciary" relationship with depositors); from beneficiaries of trusts for which the bank served as trustee, 12 C.F.R. § 9 (1995); and, in some cases, from borrowers, *Barrett v. Bank of Am.*, 229 Cal. Rptr. 16, 20-21 (Ct. App. 1986); *Barnett Bank v. Hooper*, 498 So. 2d 923, 925 (Fla. 1986). For a discussion of situations in which a bank might be considered to have a fiduciary relationship with its customer, see Neils B. Schaumann, *The Lender as Unconventional Fiduciary*, 23 SETON HALL L. REV. 21, 40-43 (1992).

The most feared of lawsuits were those by the FDIC as receiver of the failed bank asserting claims belonging to the bank for breaches of fiduciary duty arising out of the directors' failure to make decisions in the best interests of the bank.¹⁷

Such directors often faced personal liability. Although well-advised directors were covered by directors' and officers' liability insurance, the types of claims brought against them in these situations were often excluded from coverage.¹⁸ Since the typical small bank director is unlikely to be a banking professional,¹⁹ the imposition of personal

16. Directors may be subject to suit from the insurance company that bonds the bank. *FDIC v. Boone*, 361 F. Supp. 133 (W.D. Okla. 1972).

17. See, e.g., *McVane v. FDIC*, 44 F.3d 1127, 1131 (2d Cir. 1995); *Resolution Trust Corp. v. Walde*, 18 F.3d 943, 944 (D.C. Cir. 1994); *FDIC v. Canfield*, 763 F. Supp. 533 (D. Utah 1991), *rev'd*, 957 F.2d 786 (10th Cir.), *rev'd*, 967 F.2d 443 (10th Cir. 1992) (en banc). For a general discussion of suits by regulators based on claims against directors, see James T. Pitts et al., *FDIC/RTC Suits Against Bank and Thrift Officers and Directors—Why Now, What's Left?*, 63 *FORDHAM L. REV.* 2087, 2094-2102 (1995).

18. Although the FDIC officially denies that it sues all deep pockets, Alfred J.T. Byrne & Judith Bailey, *FDIC Addresses Three D&O Lawsuit Issues*, *ABA BANKING J.* 47 (Oct. 1992), it is widely believed that the FDIC often sues directors with the intent of recovering against existing director and officer liability insurance policies. R. Patrick Flynn, *Funds For the S&L Bailout: FDIC Recovery on D&O Liability Policies of Failed Depository Institutions*, *FICC Q.* 159 (Winter 1992). FDIC officials say that the agency sues at least one director of a failed institution in about 20% of all bank failures. Byrne & Bailey, *supra*. Other sources put the figure of FDIC suits against directors of failed banks at about 50%. ROBERT E. BARNETT, *RESPONSIBILITIES AND LIABILITIES OF BANK AND BANK HOLDING COMPANY DIRECTORS* 72 (1992). In many situations the specific claims asserted by the FDIC fall into the standard insurance exclusions for violations of regulations or for suits by the insured against itself. See M. Mazen Anbari, Comment, *Banking on a Bailout: Directors' and Officers' Liability Insurance Policy Exclusions in the Context of the Savings and Loan Crisis*, 141 *U. PA. L. REV.* 547 (1992); Flynn, *supra*, at 172-78; *Is D&O a Leaky Life Buoy?*, *ABA BANKING J.* 56 (Jan. 1992); see also *Chandler v. American Casualty Co.*, 833 F. Supp. 735 (E.D. Ark. 1993) (claim by Resolution Trust Corporation also within exclusion); *Abifadel v. Cigna Ins. Co.*, 9 Cal. Rptr. 2d 910 (Ct. App. 1992) (regulatory agency directives do not constitute covered claims). For a general discussion of directors' and officers' liability, see Bennett L. Ross, *Protecting Corporate Directors and Officers: Insurance and Other Alternatives*, 40 *VAND. L. REV.* 775 (1987); Edgar W. Armstrong, Jr., *Keeping Officers, Directors Protected as Insurers Pull Back*, *CORP. CASHFLOW* 30 (Apr. 1992); Stanley M. Huggins, *Protecting Your Board*, *ABA BANKING J.* 34 (June 1992).

19. Jerry Hawke, current Undersecretary of Treasury and former partner at Arnold & Porter, describes the typical small bank director as:

likely to be a local businessman or businesswoman who is neither an expert in banking nor a professional manager. Very often the director is an entrepreneur who has been successful in his or her own business. Most small banks do not take on directors for their business management expertise. Rather the principal criterion is the likelihood that the director will bring business to the bank.

John D. Hawke, Jr., *The Limited Role of Directors in Assuring the Soundness of Banks*, 1987 *ANN. REV. BANKING L.* 285, 286-87. The typical large bank directors often "are pro-

liability for obeying the demands of the sole shareholder often comes as a rude awakening.²⁰

Although the fiduciary Catch-22 for bank directors can be especially brutal, the directors of all wholly owned subsidiaries confront similar dilemmas. Directors who find themselves torn between two duties face three equally unpleasant options: first, the directors can take action that is in the best interest of the subsidiary as a corporate entity and risk either removal from their directorships by the parent-shareholder or personal liability to the parent-shareholder for breach of fiduciary duty; second, the directors can take action that is in the best interest of the parent-shareholder and expose themselves to personal liability in suits by nonshareholder constituencies, such as regulators; or third, the directors can take no action, resign their positions and wash their hands of the situation. Only the last option leaves them free of their dilemma, but simultaneously neglects the larger problem and shirks their duties. The law should not leave directors with such unsatisfactory choices.

This article examines the subsidiary director's dilemma and demonstrates that traditional models of corporate structure are not adequate for the subsidiary-parent situation described above. I argue that the law should recognize the special relationship between a parent and its subsidiary and adopt agency principles to address the question of subsidiary directors' duties within the larger corporate enterprise. Part I examines the current state of the law regarding the duties of directors of subsidiary corporations and finds that Delaware law seems to be pointing in the right direction by imposing a duty on subsidiary directors to act in the best interest of the parent. The second part of the article focuses on a larger problem: If subsidiary directors owe a duty only to the parent corporation, what happens to the duties that corporate directors generally owe to nonshareholders, including to the subsidiary corporation itself? The third part examines four possible approaches to resolving the subsidiary director's dilemma. The article concludes that subsidiary directors are in an untenable position

fessional managers who are top executives for the bank's corporate customers and thus are more sophisticated in complex business transactions than the small bank director." *Id.*

20. Because of the personal exposure facing directors, banks and other corporations are finding the recruitment of qualified directors increasingly difficult. Dan Cordtz & Jennifer Reingold, *The Vanishing Director*, CORP. FIN. 34 (Fall 1993); Lauryn Franzoni, *How To Help Your Directors Stay on Board*, BANKING WK. 1 (Feb. 2, 1992); Barbara A. Rehm, *Fearing Lawsuits, Bank Directors Take a Hike*, BANKING WK. 1 (Jan. 6, 1992); Fred Vogelstein, *For Some Bank Directors, 1991 Law Is the Last Straw*, BANKING WK. 1 (Dec. 7, 1992); *Liability Concerns Shrink Pool of Directors*, ABA BANKING J. 105 (Oct. 1992).

and should not be expected to act independently of the holding company. Instead, agency principles should require that the subsidiary directors owe a duty only to the parent corporation and that any duties owed to nonshareholders be imposed directly on the holding company.

I. To Whom Do Subsidiary Directors Owe Their Fiduciary Duties?

Although the concept of subsidiary corporations is now more than one hundred years old,²¹ clear guidance for the directors of subsidiary corporations remains elusive. Two recent efforts to clarify the underlying precepts of corporate governance, the A.B.A.'s *Corporate Director's Guidebook*,²² and the A.L.I.'s *Principles of Corporate Governance*,²³ make no special mention of the role of directors of subsidiaries.²⁴ Perhaps this silence indicates that the duties of subsidiary directors are the same as those for corporate directors generally.

Well-established law in Delaware and other jurisdictions holds that the directors of corporations owe fiduciary duties to both the corporation *and* its shareholders.²⁵ The Delaware Supreme Court has recently stated that these two duties are "of equal and independent

21. For most of the nineteenth century, corporations were generally prohibited from owning the stock of other corporations. In 1888, New Jersey became the first state to permit corporations to acquire the shares of other corporations. BLUMBERG, *SUBSTANTIVE LAW*, *supra* note 2, at 55. The subsidiary idea changed the face of American business. Corporations were formed with the intent of carrying on some of their activities through subsidiaries or to expand through the acquisition of other corporations. For a concise history of the development of the subsidiary idea, see *id.* at 55-60.

22. Section of Business Law, American Bar Association, *Corporate Director's Guidebook—1994 Edition*, 49 BUS. LAW. 1243 (1994).

23. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7.

24. In defense of the Principles of Corporate Governance, it is possible that the reason it omits explicit discussion of directors of subsidiaries is because of its limited subject matter scope. See Melvin Aron Eisenberg, *An Overview of the Principles of Corporate Governance*, 48 BUS. LAW. 1271, 1272 (1993). The Principles do discuss the duties of controlling shareholders, including specifically matters affecting parent and subsidiary. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7, § 5.11. Nevertheless, the Principles are silent on the role of the subsidiary directors.

25. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1993) ("the directors owe fiduciary duties of care and loyalty to the corporation and its shareholders.") (quoting *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) (citations omitted); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (directors owe "fundamental fiduciary obligations to the corporation and its shareholders") (footnote and citations omitted); *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors . . . stand in a fiduciary relation to the corporation and its shareholders.").

significance,"²⁶ but case law reveals that the directors' duty to the corporation as an entity usually predominates over their duty to the shareholders. Only in certain situations will the duty to the shareholders predominate over the duty to the corporation.²⁷ If the law of parent and subsidiary follows corporate law generally, it would appear that in some situations the subsidiary board should make decision in the best interests of the parent corporation as shareholder, and at other times the directors should take action in the best interest of the subsidiary as a corporation.

The courts have failed to articulate clearly the guidance necessary to permit boards to know with certainty when they owe their primary duty to one corporate constituency or another. History offers only limited help on the matter of which interests take precedence.²⁸ The classic case of *Dodge v. Ford Motor Co.*²⁹ stated that "a business corporation is organized and carried on primarily for the profit of the stockholders."³⁰ The *Dodge* case gives us the hornbook rule that directors owe their duty primarily to the shareholders,³¹ although the case itself permitted directors to use the interests of the corporation as a "proxy" for shareholder interests in the ordinary situation.³²

26. *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993).

27. At yet other times a duty to third parties deserves primacy. See *infra* notes 82-133 and accompanying text. But see John H. Matheson & Brent A. Olson, *Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law*, 78 MINN. L. REV. 1443 (1994) (arguing that the "governance tug-of-war" between various corporate constituencies is outdated and must be replaced with a system based on cooperation and dialogue in order to insure long-term financial viability for public corporations).

28. During the nineteenth century, while corporate law was in its infancy, cases raising the issue of fiduciary duties owed by a director to the corporation were rare, although some dicta suggest that such a duty existed. See EDWIN MERRICK DODD, *AMERICAN BUSINESS CORPORATIONS UNTIL 1860*, at 70-73 (1954) (discussing *Attorney General v. Utica Ins. Co.*, 2 Johns. Ch. 371 (N.Y. Ch. 1817), in which a New York equity court suggested that "the persons who . . . exercise the corporate powers may, in their character of trustees, be accountable to this court, for fraudulent breach of trust," and *Gray v. Portland Bank*, 3 Mass. 364 (1807), in which the plaintiff contended that the corporation was a trustee for its shareholders).

29. 170 N.W. 668 (Mich. 1919).

30. *Id.* at 684.

31. The *Dodge* rule was articulated as follows: "The board of directors should . . . be regarded as representative of the body of shareholders, exercising authority derived from them, and responsible in a fiduciary character to them." ROBERT H. STEVENS, *HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS* 646 (2d ed. 1949). In their famous book identifying and discussing the implications of the split between ownership interests and management interests in the corporation, Berle and Means articulated this duty as well. ADOLPH A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 220-32 (1932).

32. 170 N.W. at 684. The *Dodge* court clearly held shareholder interests to be the directors' primary responsibility, but muddled the waters by proceeding on the assumption

Subsequent case law has made it clear that a director's fiduciary duty runs to the shareholders as a class, and not to individual shareholders in their personal capacity. For example, in the 1933 case of *Goodwin v. Agassiz*,³³ the Massachusetts Supreme Judicial Court found that a corporate president or director who traded on inside information did not breach a fiduciary duty to a specific shareholder. In reaching that conclusion, the court reified the corporation and found the insider owed his duty to that artificial person, not to individual shareholders.³⁴ Central to the reasoning of the case are the ideas that the corporation is an entity that can be harmed, and that harm to a shareholder does not necessarily mean harm to the corporation.³⁵

The *Goodwin* court's view of the corporation represents a departure from the *Dodge* view. In *Dodge*, the interests of the corporation are employed to figure out the interests of the shareholders, while in *Goodwin* the corporation's interests are seen as somewhat independent and potentially different from shareholder interests.

Although the older case law was not crystal clear, it fostered the rule that, in the general operation of the corporation, when no special circumstances are present, the directors owe a duty to both the corpo-

that whatever is in the best interests of the "corporation" is also in the best interest of its shareholders. The court's belief in the identity of interests of the shareholders and the corporation is well illustrated by its statement in a part of the opinion refusing to interfere with the board's decision to pursue a business expansion plan: "assuming further that the plan and policy and the details agreed upon were for the best ultimate interest of the company and therefore of its shareholders . . ." *Id.* at 684.

33. 186 N.E. 659 (Mass. 1933).

34. *Id.* at 660. In the language of the court:

The directors of a commercial corporation stand in a relation of trust to the corporation and are bound to exercise the strictest good faith in respect to its property and business. The contention that directors also occupy the position of trustee toward individual stockholders in the corporation is plainly contrary to repeated decisions of this court and cannot be supported.

Id. (citations omitted). Finding no harm to the corporate person, the court declined to impose a duty on the insider to the shareholder. *Id.* at 661. The court did state that under special circumstances, the insider might have had an "equitable responsibility" to disclose the inside information to the shareholder. *Id.* Buying stock on the stock exchange, however, was not one of those situations. On the other hand, in face-to-face negotiations, a director might be required to disclose. *Id.* Other cases decided in the early twentieth century seem to echo the "special circumstances" test, although in those cases the facts in the plaintiffs' favor were quite compelling. See *Strong v. Repide*, 213 U.S. 419, 425 (1909) (duty imposed on buyer engaged in face-to-face dealing that was clearly deceptive); *Hotchkiss v. Fischer*, 16 P.2d 531 (1932) (duty imposed on corporate insider who took advantage of an unsophisticated widow in face-to-face dealings).

35. For a discussion and criticism of these cases, see BERLE & MEANS, *supra* note 31, at 223-26.

ration and its shareholders;³⁶ however, in ordinary situations, the interests of the corporation and its shareholders would coincide, and thus the directors should be given deference in deciding what is in the best interests of the corporation.³⁷ Over the years, however, the director's duty to the corporation in the ordinary situation has taken on a life of its own and no longer serves merely as a proxy for duty to the shareholders. In more recent cases, directors owe a duty to a "corporation" that is more than just the sum of its shareholders. In this view, the interests of the corporation and the interests of the shareholders may diverge. Two celebrated Delaware cases support the discretion of directors under the business judgment rule to make the best decision for the corporation, even if the shareholders would have preferred other action.

A. Directors Generally Owe a Duty to the Corporation

In *Unocal Corp. v. Mesa Petroleum Co.*,³⁸ Unocal received an unsolicited tender offer from T. Boone Pickens structured as a coercive two-step deal.³⁹ Unocal's board determined that Pickens's offer was not in the best interests of either the corporation or its shareholders, and implemented a self-tender plan designed to make Pickens's tender offer almost impossible to consummate.⁴⁰ The Delaware Supreme Court ultimately upheld the defensive action of the Unocal board.⁴¹ The court found that the Unocal board did not act solely or

36. See *supra* note 25 and accompanying text.

37. See, e.g., *Dodge*, 170 N.W. at 684.

38. 493 A.2d 946 (Del. 1985).

39. Pickens had a reputation for acquiring companies cheaply, breaking them up, and selling off the pieces at high prices. *Id.* at 949. The first step of the transaction called for Pickens to acquire a controlling interest in the company at \$54 per share, a premium over the market price, but arguably far short of the intrinsic value of the company, which was approximately \$75 per share. *Id.* at 949-51. At the same time, Pickens also announced the back end of the deal, which required that Unocal be merged into a Mesa Petroleum entity with the remaining Unocal shareholders receiving high risk securities with a face value of \$54. *Id.* at 949. For various reasons, front-loaded offers are comparatively rare today. See ROBERT W. HAMILTON, CORPORATION FINANCE 938 (2d ed. 1989) (citing reasons for the declining use of front loaded offers).

40. Unocal's ingenious defense wiped out Mesa's financing commitments. Roughly speaking, the plan worked as follows: upon the happening of certain triggering events, e.g., ownership of a certain percentage of Unocal stock by Pickens, Unocal would make a tender for the rest of its shares at \$72 per share, excluding the shares held by Mesa. *Unocal*, 493 A.2d at 951. The "All Holders Rule" for self-tenders has since eliminated defenses like Unocal's because it now requires the offer to be open to all holders of the class. 17 C.F.R. § 240.14d-10 (1995).

41. Interestingly, the Delaware Court of Chancery held for Mesa Petroleum, but was reversed by the Delaware Supreme Court. *Unocal*, 493 A.2d at 946. It should be noted

primarily out of a desire to perpetuate themselves in office, but instead had reasonable grounds for believing a danger to corporate policy and effectiveness existed, and that their response bore a reasonable relation to the threat posed.⁴²

Implicit in the *Unocal* holding is the understanding that the directors are primarily responsible for running the corporation's business.⁴³ Thus, a board can make decisions in the best interests of the corporation even if the shareholders would have preferred other courses of action. In reaching this conclusion, *Unocal* necessarily implies that the corporation is more than just the sum of its shareholders.⁴⁴

The idea that the interests of the corporation can take precedence over the interests of the shareholders was given further support by *Paramount Communications Inc. v. Time Inc.*⁴⁵ In that case, Time's board rebuffed an uninvited bid from Paramount with the "just say no" defense.⁴⁶ Time's board took action to consummate an already pending combination with Warner Brothers to prevent Time's shareholders from being able to choose between the Time-Warner combination and the Paramount tender offer.⁴⁷ Paramount and Time shareholders challenged Time's actions as a breach of the duty owed

that Chancellor Carolyn Berger heard the case in the chancery court and the Supreme Court opinion reversing her was written by Judge Andrew Moore. In 1994, in a politically charged appointments process, Chancellor Berger replaced Judge Moore on the Delaware Supreme Court. Richard B. Schmitt, *Delaware Judge Is Seen as Investors' Friend*, WALL ST. J., July 7, 1994, at B2. One can only speculate whether the change in court personnel will result in a change in the law.

42. *Unocal*, 493 A.2d at 954-55.

43. See, e.g., Del. Code Ann. tit. 8, § 141(a) (1991 & Supp. 1992) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . ."); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984); *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

44. The court stated that, in evaluating the threat to the corporation, the directors could consider the effects on nonshareholder constituencies, including creditors, customers, employees, and the community. *Unocal*, 493 A.2d at 955. This was not the first time that Delaware courts had recognized that in some situations corporate directors could take action protecting nonshareholder constituents. See *infra* notes 100-15 and accompanying text.

45. 571 A.2d 1140 (Del. 1989)

46. Time's board based its refusal on its belief that the offer was inadequate, conditional, failed to consider long-term prospects, and posed a threat to the "Time Culture." *Id.* at 1147-49.

47. In light of mounting pressure from Paramount's increasingly rich offers, the Time board was reluctant to submit approval of the Time-Warner deal to Time's shareholders because in all likelihood they would have rejected it in favor of the Paramount tender offer. In order to avoid shareholder approval of the transaction, Time and Warner recast their agreement as an outright acquisition of Warner by Time. *Id.* at 1148. Under relevant law and the New York Stock Exchange rules, such an acquisition did not require approval by Time's shareholders.

by Time directors to Time shareholders.⁴⁸ The Delaware Supreme Court, however, upheld the Time board's actions.⁴⁹ The court stated that the board, in making its determination about what is in the best interest of the corporation, could take into consideration factors above and beyond the maximization of short-term shareholder interests.⁵⁰

The *Time* opinion rests firmly on the premise that the corporation is an entity in its own right whose interests are not always identical with the interests of its shareholders.⁵¹ Statements in the opinion such

48. Specifically, the plaintiffs claimed that the board had a duty to facilitate the realization of the large gains promised by the Paramount offer by letting Time's shareholders vote on the deal. *Id.* at 1149. The existence of such a right of the shareholders to decide was suggested by two cases in the late 1980's. In *City Capital Associates v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988), *appeal dismissed*, 556 A.2d 1070 (Del. 1988), and *Grand Metropolitan PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988), the Chancery Court enjoined the use of poison pills and ordered the redemption of those pills on the grounds that the all-cash, all-shares tender offers could not constitute a sufficient threat to shareholder interests to justify board action that would permanently foreclose the shareholders's opportunity to accept the offers.

49. Although Paramount argued that Time's board could not pass the *Unocal* test because the Paramount all-cash, all-shares offer could not constitute a "threat" for *Unocal* purposes, the court found that Paramount's formulation of a "threat" under the *Unocal* test was too narrow. *Unocal*, 571 A.2d at 1153. The court found that situations other than the coercive two-step merger at issue in *Unocal* could be covered by the rule. *Id.* at 1152.

50. The court specifically included in the list of appropriate nonshareholder interests such things as illegality, impact on constituencies, and risk of nonconsummation. *Id.* at 1153; *see also infra* notes 100-15 and accompanying text. Because the board found several threats to Time posed by Paramount's offer, including (1) confusion over the strategic value of the combination with Warner, (2) conditions on the Paramount deal that made the competing proposals impossible to compare, and (3) confusion in the shareholder voting process because of the timing of the offer and the proxy materials, the Court was willing to defer to the judgment of the board to restructure the Warner transaction in order to avoid a shareholder vote. *Id.* Having established a reasonable perception of a threat to corporate policy, the court found the second prong of the *Unocal* test satisfied (1) because Time and Warner were merely carrying forward an already existing plan in altered form and (2) because Paramount could still make an offer on the combined company.

51. *See* Trevor S. Norwitz, "The Metaphysics of Time": A Radical Corporate Vision, 46 BUS. LAW. 377, 384-86 (1991) (suggesting that the *Time* court recognized a corporate entity to which the board of directors owed its fiduciary duties). On the other hand, some commentators have doubts about what *Time* means and whether it gives any indication of a broader theory of corporateness in Delaware. *See* Lyman Johnson & David Millon, *The Case Beyond Time*, 45 BUS. LAW. 2105 (1990):

Indeed, how can one read Delaware's takeover decisions of the past few years and see anything but a gallant but still incomplete struggle to come to grips with the larger takeover phenomenon. Thus, while in result *Time* represents a swing back towards empowering management to protect the corporate enterprise, an unwillingness to jettison the role of takeovers as important accountability instruments in corporate governance is likely to remain.

Id. at 2124.

as: "[D]irectors, generally, are obliged to chart a course for a *corporation* which is in *its* best interests . . .,"⁵² illustrate the concept of the corporation as an independent entity that has interests separate from the interests of the shareholders. Furthermore, the court explicitly acknowledged that the corporation's interests and the shareholders' interests do not always coincide when it said: "The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of *corporate goals*. That duty may not be delegated to the *stockholders*."⁵³

For most board decisions, therefore, the default rule appears to be that the directors owe their duties to the corporation as an entity. Although assessing the corporation's interests necessarily requires evaluation of shareholder interests, directors ordinarily do not owe their primary duty to the shareholders. Directors may make decisions in the corporation's best interests even when those decisions do not maximize short term shareholder value.⁵⁴ Cases arising in other contexts, however, make clear that this general rule has exceptions.

B. Sometimes Directors Owe a Duty to Shareholders

Although ordinarily corporate directors are duty-bound to take action in the best interests of the corporation, in certain circumstances, such as the sale-of-control context, directors owe their duties primarily to the shareholders. For example, *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*⁵⁵ requires that the directors take action to maximize shareholder wealth when it is clear that the corporation is going to be sold.⁵⁶

52. *Time*, 571 A.2d at 1150 (emphasis added).

53. *Id.* at 1154 (emphasis added). This position infuriated some shareholder activists, especially Robert A.G. Monks, president of Institutional Shareholder Partners, Inc., who felt that the Time-Warner transaction deprived shareholders of their voice in corporate democracy and only served to entrench management and make them less accountable. See MICHAEL T. JACOBS, SHORT-TERM AMERICA 107-14 (1991) (written by a former Bush administration Treasury Department official, who saw *Time* as wrong-headed because it insulated management by preventing the Efficient Capital Market Hypothesis from forcing them to maximize shareholder (and therefore societal) value); ROBERT A.G. MONKS & NELL MINOW, POWER AND ACCOUNTABILITY 93-107 (1991).

54. *Time*, 571 A.2d at 1150.

55. 506 A.2d 173 (Del. 1986).

56. In *Revlon*, the Delaware Supreme Court invalidated a "lock-up" option granted by Revlon to Forstmann Little & Co., a white knight bidder. Forstmann made the lock-up option a condition of its friendly bid in response to the hostile takeover by Ron Perelman. *Id.* at 178-79. The option, which effectively killed a bidding contest for Revlon, would have allowed Forstmann to acquire two of Revlon's most desirable divisions for \$100 to \$175 million less than their appraised value if another bidder acquired more than 40% of Rev-

The *Revlon* court held that, in the change-of-control context, the directors' duty to the shareholders supersedes their general duty under *Unocal* to act in the corporation's best interests.⁵⁷ The Delaware Supreme Court recently followed *Revlon* in *Paramount Communications Inc. v. QVC Network Inc.*⁵⁸ The *QVC* court read *Revlon* to impose special duties on directors in all sale-of-control situations where shareholders are not adequately protected by the ordinary fidu-

lon's shares. *Id.* The court found that, in offering the lock-up to Forstmann, *Revlon's* board had breached its duty to its shareholders. *Id.* at 182-84. The court stated that while the *Unocal* decision sanctions the board's power to enact plans designed to frustrate a bust-up acquisition or a coercive offer, once a sale becomes inevitable, the directors' duties shift from being focused primarily on protecting the corporation to instead acting to maximize shareholder values by ensuring a fair auction of the corporation:

The *Revlon* board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the company was for sale. The duty of the board had thus changed from the preservation of *Revlon* as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.

Id. at 182. Some commentators have suggested that if "*Revlon* duties" ever did exist they no longer do because Delaware has moved toward a unitary standard for evaluating board conduct. See Lawrence A. Cunningham & Charles Yablon, *Delaware Fiduciary Duty Law after QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?)*, 49 BUS. LAW. 1593 (1994). As the authors themselves admit, however, their interpretation is one among many, and the current state of Delaware law remains a mystery. *Id.* at 1594-96.

57. 506 A.2d at 182. Recognizing a duty to maximize shareholder value in the sale-of-control context raises some tough questions. The most difficult issue is determining when the directors' duty switches from protecting the corporation's interests to maximizing shareholder value. In *Time*, the court stated that *Revlon* duties are implicated in at least two situations: (1) when a company initiates the auction process by putting itself in play; or (2) when, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving break up of the company. *Paramount Communications Inc. v. Time Inc.*, 571 A.2d at 1150. In *Time*, the court refused to impose *Revlon* duties on transactions that resulted in putting the corporation "in play" or "up for sale" if the transaction did not also involve the abandonment of long term plans. *Id.* at 1150-51. In addition, the *Time* court held that "[d]irectors are not obligated to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." *Id.* at 1154.

Another question raised by the existence of *Revlon* duties concerns how the board should conduct the auction of the corporation once the switch of duties has occurred. This question has been addressed in the cases of *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286-87 (Del. 1988) (concluding that there is no prescribed formula for auctions as long as the board's primary purpose is to enhance the bidding process for the shareholders's benefit); *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del. 1989) (noting the board's "active and direct role in the sale process"); and *In re RJR Nabisco Shareholders Litigation*, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194, at 91,715 (Del. Ch. Jan. 31, 1989) (court deferred to board in selecting one of two substantially similar bids under business judgment rule and found that *Revlon* did not impose additional requirements on the auction process). Further analysis of the auction process is beyond the scope of this article.

58. 637 A.2d 34 (Del. 1993).

ciary duties owed to them by the directors.⁵⁹ Viewed solely as a sale-of-control case, the *QVC* opinion's focus on shareholder rights over independent corporate rights is neither surprising nor inconsistent with previous cases because the interests of the corporation *as a corporation* were not affected in the underlying transaction while clearly the interests of the shareholders were.⁶⁰

C. General Corporate Duties in the Subsidiary Context

Even if we could identify with certainty the duties owed by directors generally, a moment's reflection reveals that the transplantation of ordinary director duties to the wholly owned subsidiary context is unrealistic. The duties imposed on directors generally do not make sense within the special case of the parent-subsidiary relationship. The parent corporation's domination over the affairs of the subsidiary makes it unlikely that subsidiary directors will ever take any non-shareholder interests into account, including the interests of the "corporation," assuming that such an entity has interests that differ from the shareholder's interests.⁶¹ Even though, under *Revlon*, the shareholder's interest should take precedence only in the sale-of-control context, directors of subsidiary corporations will be hard-pressed to make decisions in the best interests of the "corporation" that are contrary to the interests and orders of its shareholder-parent.

Torn between two conflicting duties, the directors of subsidiary corporations face the "horizontal conflict" problem identified by Lawrence Mitchell.⁶² Horizontal conflicts occur when directors owe duties

59. *Id.* at 46-48. In an apparent narrowing of *Time*, the *QVC* court held that "*Revlon* . . . does not hold that an inevitable dissolution or 'break-up' is necessary" to shift the directors' duties. *Id.* at 46. The *QVC* court did not see this as inconsistent with the *Time* holding because the *Time* opinion said that the two enumerated instances when *Revlon* was implicated were prefaced by the phrase "generally speaking and without excluding other possibilities." *Id.* at 49. The *QVC* case was apparently one of these "other possibilities."

60. On the other hand, some commentators have suggested that *QVC* is more than just another *Revlon*-type case and is instead a reassessment of the general standard of care. See Paul L. Regan, *The Unimportance of Being Earnest: Paramount Rewrites the Rules for Enhanced Scrutiny in Corporate Takeovers*, 46 HASTINGS L.J. 125 (1994) (suggesting that *QVC* indicates judicial encroachment on director discretion that has historically been protected by the business judgment rule); Cunningham & Yablon, *supra* note 56 (suggesting that *QVC* and other recent cases indicate a new unified standard of director action that does not hinge on the type of transaction).

61. As a matter of organizational theory, subsidiaries tend to be "instruments," that is, they exercise little autonomy and are dominated by an external coalition. See HENRY MINTZBERG, *POWER IN AND AROUND ORGANIZATIONS* 308-09, 329 (1983).

62. Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 603-07 (1992).

to more than one constituency and are charged with making sure that all the constituencies get their due, even though the interests of the shareholders tend to dominate the decision-making process.⁶³ As Professor Mitchell has pointed out, although the law has developed several methods to protect the corporation against director self-dealing, there are few mechanisms in place to insure that directors properly discharge their duties to nonshareholder constituencies in a horizontal conflict situation.⁶⁴

Horizontal conflicts arise as a result of the interplay of several threads of corporate law. Directors are supposed to act in the best interests of the corporation⁶⁵ and the corporation consists of more than just the sum of its shareholders.⁶⁶ However, to discourage self-dealing, only shareholders have standing to derivatively sue directors for breaches of duty to the corporation.⁶⁷ Logically, shareholders are unlikely to bring a derivative action for the protection of "corporate" interests unless their own interests are sufficiently affected.⁶⁸ Conse-

63. *Id.*

64. Mitchell refers to self-dealing as a "vertical conflict." *Id.* at 591. For example, derivative suits are useful mechanisms to keep vertical conflicts in check because they allow shareholders to initiate an action to compel the directors to bring a legal action on behalf of the corporation and in some situations permit shareholders to prosecute the action without the involvement of the directors. 13 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5941.10 (perm. ed. rev. vol. 1991).

65. See *supra* notes 38-54 and accompanying text.

66. See *supra* notes 44, 52-53, and accompanying text.

67. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7, § 7.02 (authorizing holders of "equity securities" (including securities convertible into equity) and in some cases directors, to commence and maintain derivative actions). Traditionally, convertible security holders were denied standing. See *Kusner v. First Pa. Corp.*, 395 F. Supp. 276 (E.D. Pa. 1975), *rev'd*, 531 F.2d 1234 (3d Cir. 1976). But see *Hoff v. Sprayregan*, 339 F. Supp. 369 (S.D.N.Y. 1971). Mere creditors traditionally have fared even worse than convertible security holders. See *Haberman v. Washington Pub. Power Supply Sys.*, 744 P.2d 1032, 1061 (Wash. 1987) (en banc) (bondholders have no standing to sue derivatively), *modified*, 750 P.2d 254 (Wash. 1988), *appeal dismissed*, 488 U.S. 805 (1988).

68. It has been argued that the U.S. system of state-level corporate law has a built-in dynamic that produces statutes catering to shareholder interests to the exclusion of nonshareholder interests. Lucian Bebchuk has demonstrated that although economically efficient (and therefore socially desirable) statutes would take into account the interests of shareholders and nonshareholders alike, the interstate competition for corporate charters results in the development of statutes that appeal to the people who choose where to incorporate, and those people will choose laws that maximize shareholder value. Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1485 (1992). The areas of corporate law that have significant nonshareholder interests, but which for competitive reasons are given short shrift, include regulation of takeover bids and proxy contests, protection of creditors, regulation of corporate disclosure, and protection of constituencies other than providers of capital. *Id.* at 1486-93.

quently, because nonshareholder constituents of the corporation have no effective method for holding directors accountable when directors fail to discharge their duties appropriately in the horizontal conflict situation, their interests tend to be protected only when they coincide with the interests of the shareholders.

The significance of this dynamic is not lost on directors generally, and subsidiary directors doubtlessly understand this mechanism with particular clarity. They understand that ultimate control of the corporation rests with the shareholders, who can either sell their shares to other investors or vote different directors into office. The directors also understand that the shareholders are the only group that can sue the board on behalf of the corporation. This centralization of power in the shareholders focuses director attention on shareholder interests to the exclusion of other interests.⁶⁹ As Professor Mitchell has observed, the mismatch between the duty owed to all the constituents of the corporation and an enforcement mechanism that allows only shareholders to bring derivative actions causes nonshareholder constituents to bear more than their share of the risk of detrimental director action.⁷⁰

While Professor Mitchell recognized that horizontal conflicts may occur in any corporation, they are especially severe in context of the wholly owned subsidiary. If subsidiary directors owe the same duties as directors of corporations generally, the subsidiary directors may often encounter horizontal conflicts on a regular basis. Additionally, unlike the directors of a publicly traded corporation whose shareholders may be widely scattered, poorly organized, and more likely to sell their stock than to bring a derivative suit, the directors of the wholly owned subsidiary have their one and only shareholder looking over their shoulders on a regular basis. Since the parent entirely controls the subsidiary's management,⁷¹ it is unrealistic to expect the subsidiary directors to act solely in the best interests of the subsidiary corporation even though such action would ordinarily be required for corporate directors.⁷² Instead of requiring these directors to behave as if the subsidiary were an independent entity, the law should be

69. Mitchell, *supra* note 62, at 605-07.

70. In effect, the mismatch produces negative economic externalities that are borne by the nonshareholder constituents. Mitchell, *supra* note 62, at 606; *see also* Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 182 n.34 (implicitly acknowledging the existence of externalities in this situation).

71. EISENBERG, *supra* note 1, at 299-300.

72. *See supra* notes 38-54 and accompanying text.

more realistic and allow them to do the bidding of the parent or shareholder. Allowing this behavior requires a special rule of corporate law, however, because directors may not normally place shareholder interests ahead of corporate interests.⁷³

Historically, the law has treated a parent corporation and its subsidiaries as independent entities. To provide a "[w]orking chart of proper parent and subsidiary corporation management," a treatise on parent and subsidiary corporations written more than sixty years ago unequivocally stated: "The subsidiary's directors . . . must, of course, run the business in its own interest. They must not be improvident with its resources even though their action may, for extraneous reasons, benefit the parent corporation."⁷⁴ Implicit in this statement is a conception of the parent and the subsidiary as separate legal entities, just as all corporations are juridical persons separate and distinct from their shareholders.

As courts, commentators, and practitioners have begun to accept a more sophisticated view of corporate enterprise, rigid adherence to the independent-entity model of corporate affiliates has become less common. Yet despite the growing belief that nineteenth century corporate theory has become anachronistic in the modern world of complex corporate groups,⁷⁵ cases dealing with subsidiary corporations continue to draw on the traditional independent-entity paradigm without taking meaningful countenance of the special situation of subsidiaries. For example, in *Capital Parks, Inc. v. Southeastern Advertising and Sales System, Inc.*,⁷⁶ the Fifth Circuit held that a plaintiff's right of first refusal from a parent corporation to purchase all the outstanding capital stock of a subsidiary corporation was not triggered when a third party acquired all of the parent corporation's assets. The court reasoned that the wholly owned subsidiary was a "separate legal entity possessing its own separate assets and liabilities;"⁷⁷ thus, the parent had no authority to transfer the assets of the subsidiary.⁷⁸ It is unclear upon what operative facts the court based its decision, but regardless, the case reaches an overly formalistic and ultimately unfair result. The subsidiary was entirely controlled by the parent, yet the

73. See *supra* notes 55-60 and accompanying text.

74. FREDERICK J. POWELL, PARENT AND SUBSIDIARY CORPORATIONS 110 (1931).

75. PHILLIP I. BLUMBERG & KURT A. STRASSER, THE LAW OF CORPORATE GROUPS: STATUTORY LAW: SPECIFIC § 32.02 (1992) [hereinafter BLUMBERG & STRASSER, STATUTORY LAW: SPECIFIC].

76. 30 F.3d 627 (5th Cir. 1994).

77. *Id.* at 629.

78. *Id.*

court made no attempt to take that domination into account. Instead the court's inappropriate use of the independent-entity paradigm compelled it to conclude that the parent corporation could not affect the policies of the subsidiary. This conclusion is unrealistic and an example of the problems resulting from the application of the traditional corporate paradigm to subsidiaries.

Unfortunately, few cases present a more sophisticated understanding of the parent-subsidiary relationship. Since parent-shareholders are likely to be the only corporate constituency with standing to challenge action by subsidiary directors, and since parent-shareholders of wholly owned subsidiaries have other methods of keeping subsidiary directors in line, the reported cases dealing with this relationship are scarce.

Nevertheless, some support exists for the idea that the law should treat the directors of wholly owned subsidiaries differently. For example, in the 1988 case of *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*,⁷⁹ the Supreme Court of Delaware unequivocally stated that "in a parent and wholly owned subsidiary context, the directors of the subsidiary are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders."⁸⁰ The court's underlying principle is correct—it is unrealistic to expect the directors of wholly owned subsidiaries to do anything but serve the interests of the parent. However, although the *Anadarko* decision reaches a correct result in terms of the parent-subsidiary dynamic, it fails to address the deeper issues confronting subsidiary directors. Those issues result

79. 545 A.2d 1171 (Del. 1988).

80. *Id.* at 1174. The facts of *Anadarko* deserve some development. *Anadarko Petroleum Corp.* ("Anadarko") was a wholly owned subsidiary of *Panhandle Eastern Corp.* ("Panhandle"). *Id.* at 1173. Panhandle and some of its other subsidiaries were engaged in the business of running natural gas pipelines. *Id.* Anadarko was engaged in the business of developing and extracting oil. *Id.* Panhandle's board of directors decided to divest itself of Anadarko by spinning off the subsidiary to the existing shareholders of Panhandle. *Id.* After the spin-off, Anadarko shares would be listed on the New York Stock Exchange. *Id.* In the information statement distributed to its shareholders regarding this spin-off transaction, Panhandle indicated that it would continue to do business with Anadarko after the spin-off. *See id.* at 1176. Toward that end, prior to the spin-off, Panhandle and Anadarko renegotiated several intra-corporate contracts so that the renegotiated contracts were much more favorable to Panhandle. *Id.* at 1173-74. After the spin-off, Anadarko's new board of directors sued Panhandle to void the renegotiated contracts. *Id.* at 1174. The *Anadarko* court did not impose a burden of showing "entire fairness" on Panhandle, because a fiduciary duty would arise only if Panhandle and the original Anadarko board had held a fiduciary position with respect to the future stockholders of Anadarko and had engaged in self-dealing to the detriment of those shareholders. *Id.* at 1175. The court found no such duty. *Id.* at 1174-75.

from the conflicting duties that subsidiary directors owe to not just the corporation and its shareholders, but other parties as well.

II. Beyond *Anadarko*—Considering the Subsidiary Directors' Duties to Nonshareholders

The *Anadarko* case avoids the important and difficult question of what happens to the other duties owed by the directors of the subsidiary. In addition to the duties to shareholders recognized in the *Anadarko* decision, directors of corporations generally owe duties to the corporate entity⁸¹ and sometimes owe duties to creditors or other constituencies. The *Anadarko* decision's emphasis on shareholder interests does not adequately explain what happens to the duties owed to nonshareholders in the subsidiary situation.

A. Duties of Directors to Nonshareholders

Application of *Anadarko* in the real world presents serious problems because it fails to consider duties that may be owed to non-shareholder constituents. These duties arise under both case and statutory law, and are increasingly championed in academic literature.

(1) Duties to Creditors

For example, some case law holds that when a corporation is in financial distress (insolvent, or in the vicinity of insolvency), the directors of the troubled corporation owe a duty to the corporation's creditors.⁸² In the famous case of *Pepper v. Litton*,⁸³ Justice Douglas stated that a director's fiduciary duty is "designed for the protection of the *entire community of interests in the corporation*—creditors as well as stockholders."⁸⁴ Read broadly, the *Pepper* case establishes the principle that, in the financial distress situation, directors may not maximize shareholder benefit if that action will be inequitable to other constituents who have a connection to the corporation.

Other case law supports the *Pepper* principle. Several cases hold that directors must manage an insolvent corporation's assets as if they

81. See *supra* notes 38-54 and accompanying text.

82. For a comprehensive discussion of this duty, see Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995).

83. *Pepper v. Litton*, 308 U.S. 295 (1939).

84. *Id.* at 307 (emphasis added).

were in trust for creditors.⁸⁵ Although this duty to creditors is limited, the courts have noted the difficulty of applying such a duty in the real world.⁸⁶ While some older Delaware cases applied the trust fund theory with some enthusiasm,⁸⁷ more recent cases are somewhat more circumspect.⁸⁸

Despite this hesitation, some cases have extended the directors' duty to consider nonshareholder interests, specifically creditor interests, to situations in which the corporation is merely "in the vicinity" of insolvency. In *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*,⁸⁹ a Delaware Court of Chancery held:

[W]here a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [i.e. shareholders], but owes its duty to the corporate enterprise [The board of directors] had an obligation to the *community of interest* that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.⁹⁰

85. See, e.g., *In re STN Enters.*, 779 F.2d 901, 904 (2d Cir. 1985) (finding that directors of an insolvent corporation owe a fiduciary duty to creditors); *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953) (holding that if the corporation is insolvent or is approaching insolvency, the corporation's directors and officers are obligated to protect the property for the corporate creditor-beneficiaries).

86. For example, it appears that the duty to creditors does not exist in the normal operation of the corporation. See, e.g., *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 n.33 (S.D.N.Y. 1989) (refusing to impose fiduciary duty on the corporation's director in cases that do not involve fraud or insolvency); *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) (holding that directors owe no fiduciary duty to convertible debenture holders); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev'd on other grounds*, 347 A.2d 133 (Del. 1988) (holding that directors owe fiduciary duty to debenture holders only in "special circumstances" including insolvency, fraud or illegality). But see *Allied Indus. Int'l, Inc. v. AGFA-Gevaert, Inc.*, 688 F. Supp. 1516, 1521 (S.D. Fla. 1988) (concluding that directors do owe a duty to creditors of the corporation). For a general discussion, see William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 Wis. L. Rev. 667; Morey W. McDaniel, *Bondholders and Stockholders*, 1988 J. Corp. L. 205; Morey W. McDaniel, *Bondholders and Corporate Governance*, 41 Bus. Law. 413 (1986).

87. *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808 (Del. 1944) (applying trust fund doctrine in reversing a lower court ruling granting a motion to dismiss in the case of an especially egregious abuse of the corporate franchise that operated as a fraud on creditors); *Pennsylvania Co. for Ins. v. South Broad St. Theatre Co.*, 174 A. 112, 116 (Del. Ch. 1934) (recognizing "trust fund" doctrine as a shorthand expression of the principle that directors should of an insolvent corporation act honestly and fairly); *Asmussen v. Quaker City Corp.*, 156 A. 180, 181-82 (Del. Ch. 1931) (recognizing trust fund doctrine, but refusing to apply it strictly).

88. See *In re Rego Co.*, 623 A.2d 92, 95 (Del. Ch. 1992) (apparently limiting the Delaware version of the trust fund theory to dissolution of the corporation).

89. *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at *107-109 (Del. Ch. Dec. 30, 1991).

90. *Id.*

In reaching this holding, the court relied on a view of the corporation as a legal and economic entity whose interests do not necessarily coincide with the interests of its shareholders.⁹¹

Although the *Credit Lyonnais* opinion generated criticism,⁹² its basic premise was followed in *Geyer v. Ingersoll Publications Co.*⁹³ In *Geyer*, the chancery court again concluded that the directors owe a fiduciary duty to creditors upon insolvency.⁹⁴ The *Geyer* court explained that because the interests of the "corporate enterprise" had to be served, the directors should not limit their concerns to the shareholder interests only.⁹⁵ Just how broad these other duties are remains unclear. Unfortunately, it is an area of director duty left untouched by the A.L.I. Principles of Corporate Governance.⁹⁶

(2) Duties to "Other Constituencies"

In addition to their duties to creditors, corporate directors may owe duties to (or at least may be permitted to take into account the interests of)⁹⁷ other constituencies of the corporate enterprise.⁹⁸ For example, directors may be permitted to consider these other interests as a way to maximize long-term corporate success, even at the sacri-

91. *Id.* at *108 n.55. Chancellor Allen was quite explicit about the dichotomy between corporate interests and shareholder interests: "that result [protecting creditors] will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors capable of conceiving of the corporation as a legal and economic entity."

92. Martin J. Bienenstock, *Conflicts Between Management and the Debtor in Possession's Fiduciary Duties*, 61 U. CIN. L. REV. 543, 555-56 (1992); C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on Credit Lyonnais*, 19 J. CORP. L. 61 (Fall 1993); Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of the Directors of the Financially Troubled Company*, 48 BUS. LAW. 239 (1992).

93. 621 A.2d 784 (Del. Ch. 1992).

94. *Id.* at 789-90.

95. As the court explained:

The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors only concern.

Id. at 789.

96. For a discussion of this issue, see Deborah A. DeMott, *Down the Rabbit-Hole and into the Nineties: Issues of Accountability in the Wake of Eighties-Style Transactions in Control*, 61 GEO. WASH. L. REV. 1130, 1150-54 (1993).

97. Although the courts have not yet imposed a duty to other constituencies in situations other than creditor protection, case law indicates that the board of directors are not obligated solely to the shareholder, but also to the stakeholder interests. Mitchell, *supra* note 62, at 610-30.

98. "Other constituencies" may include employees, customers, suppliers, communities in which the corporation operates, bondholders, and virtually any other group with a connection to the corporation.

fice of short-term shareholder gain.⁹⁹ These duties to other constituencies may be created by case law or by statute.

(a) Case Law

In Delaware, the common law rule governing when corporate directors may account for the interests of "other constituencies" has evolved over many years.¹⁰⁰ In recent years, however, the Delaware Supreme Court's views appear to have seesawed back and forth. On closer examination, however, these apparent vacillations can be explained. In the 1985 *Unocal*¹⁰¹ decision, the Delaware Supreme Court stated that when a board makes a decision in the best interests of the corporation, it may consider, among other things, the impact of the corporate action on constituencies other than the shareholders.¹⁰² Since in situations not involving sale of control the directors are supposed to make their decisions in the best interests of the corporation,¹⁰³ consideration of nonshareholder constituents is appropriate.

In contrast, the *Revlon*¹⁰⁴ line of decisions downplays the consideration of nonshareholder interests. In the *Revlon* situation, nonshareholder interests play a more attenuated role, because shareholder interests take precedent over those of the corporation. While not dismissing the concerns of nonshareholder constituents entirely, the *Revlon* court curtailed the consideration of those interests

99. Matheson & Olson, *supra* note 28, at 1465; see also Mitchell, *supra* note 62, at 605-10 (arguing that standard corporate rules restraining director self-interest create unintended externalities, but noting that these externalities may be allocated under other constituency statutes among the parties benefitting from the self-interest rules).

100. The idea has arisen periodically in Delaware corporate jurisprudence since at least the early 1960s. In *Kors v. Carey*, 158 A.2d 136 (Del. Ch. 1960), the directors of a cosmetics and household drug manufacturer decided to use corporate funds to buy out a large shareholder who owned a chain of drugstores. *Id.* at 138-39. The directors were motivated in part by fear that the shareholder's designs for gaining control of the manufacturer could result in strained relations with the manufacturer's other customers, who were competitors of the shareholder in the drugstore business. *Id.* at 139-40. In the suit brought by a minority shareholder, the court held that the directors' action was not a violation of directors' fiduciary duty because it was motivated in part to protect existing customers from the whims of this shareholder. *Id.* at 141-42. In *Cheff v. Mathes*, 199 A.2d 548 (Del. 1964), the directors decided to use corporate funds to redeem the shares of a shareholder who had a "poor reputation." *Id.* at 556. The fact that the director action was motivated in part for the purpose of avoiding employee unrest was not a violation of the directors' fiduciary duty. *Id.*

101. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

102. *Id.* at 955-58.

103. See *supra* notes 38-54 and accompanying text.

104. See *Revlon, Inc. v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182-83 (Del. 1986).

by saying that "[a]lthough such considerations may be permissible, there are fundamental limitations upon that prerogative. A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the shareholders."¹⁰⁵

In the language of the *Revlon* court, concern for nonshareholder constituencies in the change-of-control context is "inappropriate" because the "object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder."¹⁰⁶ This language supports the idea that the concept of the "corporation" includes the interests of nonshareholders. This language implies a difference between maintaining the "corporate enterprise" (in which context concern for nonshareholders is appropriate) and maximizing shareholder value (*i.e.*, selling the shareholder interests to the highest bidder).

By focusing on shareholder benefits, *Revlon* seemed to dispel any inkling of an independent duty running from the directors to nonshareholder constituencies. However, the *Revlon* case dealt with what constituted the best interests of the shareholders in the sale-of-control context, not (as in *Unocal*) with director decisions about the best interests of the corporation.¹⁰⁷ Because *Revlon* requires a board to shift its duties from the corporation as a whole to focus solely on short-term shareholder wealth maximization, the court properly marginalized nonshareholder interests.

Revlon, however, did not spell the end of director concern for nonshareholder interests. In 1987, the Delaware Supreme Court reiterated the *Unocal* language in *Ivanhoe Partners v. Newmont Mining Corp.*,¹⁰⁸ a case in which *Revlon* duties were not triggered. In considering the best interests of the corporation, the target's board was allowed to consider the interests of nonshareholder constituencies.¹⁰⁹ In 1989 the court included language similar to that of *Revlon* in *Mills Acquisition Co. v. Macmillan, Inc.*,¹¹⁰ a case involving *Revlon* duties.¹¹¹ As would be expected in a *Revlon* situation, *Mills Acquisition*

105. *Id.* at 182.

106. *Id.*

107. *See Revlon*, 506 A.2d 173.

108. 535 A.2d 1334, 1341-42 (Del. 1987).

109. *Id.* at 1341-42 ("[T]he board may under appropriate circumstances consider . . . the impact on constituencies other than shareholders . . .").

110. 559 A.2d 1261 (Del. 1989).

111. The court stated that in the context of running an auction and deciding whether to accept an offer, the board could consider "the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests." *Id.* at 1282 n.29.

held that the board must put the interests of the shareholders above the interests of the corporation.¹¹² Thus, consideration of the interests of nonshareholder constituencies will be appropriate only if it bears a "reasonable relationship" to the interests of the shareholders.¹¹³

The two most recent important cases, *Time*¹¹⁴ and *QVC*,¹¹⁵ also bear out the dichotomy between *Revlon* situations and non-*Revlon* situations. In *Time*, a non-*Revlon* case, the court approved the board's recognition of nonshareholder interests as an appropriate part of the determination of what is best for the corporation.¹¹⁶ Not surprisingly, the opinion in *QVC*, which concerned a *Revlon* situation, makes no mention of the "other constituencies" who might benefit from director action. Of course, *QVC* cites *Revlon* with approval,¹¹⁷ so one would surmise that the *Revlon* nonshareholder interest rule still stands.

(b) Statutory Law

Although Delaware case law supports director consideration of nonshareholder interests when determining what course of action is in the corporation's best interest, a more important phenomenon in most states has been the enactment of "other constituency" statutes.¹¹⁸ A large number of states have passed laws permitting directors to consider nonshareholder interests when making corporate decisions.¹¹⁹

112. *Id.* at 1280.

113. *Id.* at 1288. The "reasonable relationship" language of *Mills* and the "rationally related benefit" language of *Revlon* appear to mean the same thing. See James J. Hanks, Jr., *Playing With Fire: Nonshareholder Constituency Statutes in the 1990s*, 21 STETSON L. REV. 97, 101 n.25 (1991).

114. *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989).

115. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993).

116. 571 A.2d at 1153; see *supra* notes 45-54 and accompanying text.

117. 637 A.2d at 46-48.

118. At least twenty-eight states have enacted other constituency statutes. For a summary of these laws in tabular format, see Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, 194-96 (1991).

119. Maine's corporate constituency statute is fairly typical of the permissive, but not mandatory, nature of these provisions. It states that:

In discharging their duties, the directors and officers may, in considering the best interests of the corporation and of its shareholders, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.

ME. REV. STAT. ANN. tit. 13-A, § 716 (West Supp. 1994). Connecticut's "other constituency" provision, on the other hand, appears to be unique in that it *requires* the board to take into consideration the "long-term" interests of the corporation and its shareholders, the interests of employees, customers, creditors, and suppliers and "community and socie-

These statutes raise many questions, such as whether they give nonshareholders standing to sue for failure to consider their interests; how much weight, if any, can or must be given to nonshareholders' interests; and what standards should guide directors in considering these interests.¹²⁰ Although the statutes have been widely criticized by legal commentators,¹²¹ the widespread adoption of these statutes may show that the states believe the corporation concept extends beyond shareholders to reach stakeholders as well.¹²² If so, the real function of the statutes is to help the directors achieve their primary goal of discharging their duty to the *corporation*, with the understanding that "corporation" is broadly defined to include all constituents that contribute to the corporate enterprise.¹²³ This broad view of the corporation has been advanced by "communitarian" corporate scholars.¹²⁴ In conscious opposition to the libertarian aspects of the contractarian approach to corporations, a group of scholars have set out to place corporations in a larger context through the development of so-called "communitarian" theories of the corporation.¹²⁵ Drawing

tal considerations" when making decisions in connection with the merger or the sale of substantially all the assets of a publicly traded Connecticut corporation. CONN. GEN. STAT. ANN. § 33-313 (West Supp. 1995).

120. See, e.g., Charles Hansen, *Other Constituency Statutes: A Search for Perspective*, 46 BUS. LAW. 1355, 1369-70 (1991) (discussing the impact of other constituency statutes).

121. See, e.g., William J. Carney, *Does Defining Constituencies Matter?*, 59 U. CIN. L. REV. 385 (1990); Hanks, *supra* note 113; Jonathan R. Macey, *An Economic Analysis of the Various Rationales for Making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties*, 21 STETSON L. REV. 23 (1991) (arguing that the "gap-filling" function of the fiduciary duty should apply only to the director-shareholder relationship because of the difficulties of providing explicit contractual mechanisms to cover all aspects of that dynamic, while on the other hand, nonshareholder constituents do possess adequate contractual protections).

122. Matheson & Olson, *supra* note 27, at 1466. Other commentators have applauded these laws as the best hope for aligning director action with the long-term interests of the shareholders, the stakeholders, and the corporation. See, Mitchell, *supra* note 62, at 589-90 (arguing that the duty of the directors is broadly defined). Confusion between the existence of duty and the enforcement of duty arises in cases because the shareholders are the only constituents with the power to enforce the directors' duty in most situations. *Id.* at 603; Wallman, *supra* note 118; David Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223 (1991) (discussing the effect of other constituency statutes in a balanced, generally positive tone).

123. See *supra* notes 38-54 and accompanying text.

124. For a discussion of the contractarian approach as seen through the eyes of a communitarian, see David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1377-78 (1993) and *infra* notes 185-204 and accompanying text.

125. For a general discussion of the contract versus community debate, see William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395 (1993); see also Millon, *supra* note 124, at 1391-93 (providing a bibliography of communi-

on the legal authority developed in the preceding section and incorporating theoretical justifications, the arguments of these scholars may find their way into the mainstream of corporate law and eventually influence judicial decisions.

The developments in the case law, statutes, and academic literature seem to have affected the development of the A.L.I. Corporate Governance Project. It provides support for certain director action that does not enhance short-term shareholder wealth.¹²⁶ Although the Principles of Corporate Governance state that the objective of the corporation is "the conduct of business activities with a view to enhancing corporate profit and shareholder gain,"¹²⁷ a comment adds:

The modern corporation by its nature creates interdependencies with a variety of groups with whom the corporation has a legitimate concern, such as employees, customers, suppliers, and members of communities in which the corporation operates. The long-term profitability of the corporation generally depends on meeting the fair expectations of such groups. Short-term profits may properly be subordinated to recognition that responsible maintenance of these interdependencies is likely to contribute to long-term profitability and shareholder gain.¹²⁸

The Principles also permit the corporation to use a "reasonable amount" of its resources for "public welfare, humanitarian, educational, and philanthropic purposes,"¹²⁹ even when there is no enhanced profit to the corporation.¹³⁰ Nevertheless, the Principles do not establish a duty on the directors to act on behalf of the non-shareholder interests.¹³¹

As discussed above, it appears that corporate directors may owe fiduciary duties to different constituencies depending on the context in which they are acting.¹³² Ordinarily, directors owe their primary

tarian scholarship in the corporate law field); David Millon, *State Takeover Laws: A Re-birth of Corporation Law?*, 45 WASH. & LEE L. REV. 903 (1988) (heralding the emergence of an approach to corporate law that seeks to address important questions about the relationship between corporations and society).

126. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7, § 201(a).

127. *Id.*

128. *Id.* § 2.01 cmt. f.

129. *Id.* § 2.01(b)(3).

130. *Id.* § 2.01 cmt. i; *see also* Eisenberg, *supra* note 24, at 1276-77 (stating that corporations may use resources without showing a direct benefit to the corporation).

131. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7, § 2.01 cmt. h. For a criticism that the A.L.I. PRINCIPLES fail to adequately address the significance of the stakeholder empowerment movement of the 1980s, *see* Roberta S. Karmel, *Implications of the Stakeholder Model*, 61 GEO. WASH. L. REV. 1156 (1993).

132. A fiduciary duty that presents such a moving target may be hard to accept, but it appears that is where Delaware law at least presently resides. Herbert M. Wachtell, of

fiduciary duty to the "corporation," which may include non-shareholder interests. However, in change-of-control transactions, the short-term profit interests of shareholders move to the fore; and in the insolvency context, a duty to creditors may arise.¹³³ None of these duties are expressly limited to non-subsidiary corporations. Therefore, these general duties of corporate directors may bind subsidiary directors as well.

B. Placing *Anadarko* in the Nonshareholder Duty Context

If directors of subsidiaries, like those of other corporations, must or may take into account the interests of nonshareholders, how does that consideration fit with the *Anadarko* assertion that the subsidiary directors owe a duty only to the parent corporation? Are the duties to nonshareholders extinguished or are they imposed on the parent?¹³⁴ The *Anadarko* decision itself seems to rule out the idea that the parent inherits the duties to the subsidiary "corporation," by stating that "a parent does not owe a fiduciary duty to its wholly owned subsidiary."¹³⁵ That leaves a conundrum: if directors ordinarily owe a duty to their corporation, but in the wholly owned subsidiary context they

Wachtell, Lipton, Rosen & Katz, New York, who successfully represented Time-Warner in *Paramount Communications Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989), and who also successfully represented QVC in *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1993) on what seemed to be the opposite side of a similar matter, has opined that corporate transactions will be examined on an individual basis. The temptation to distill the duties into formulas will backfire, he suggests, by saying "[p]eople like formulas, people like certainty [but] life is not simple." *New Territory or Familiar Soil? Some See Revolution, Others See Evolution in Delaware's Paramount/QVC Case*, BNA CORP. COUNS. WKLY., Apr. 20, 1994, at 6. In a similar vein, the first paragraph of Professor DeMott's examination of fiduciary duties includes the following statement: "Recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis." Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 DUKE L.J. 879.

133. Some commentators have suggested that the Delaware decisions provide different standards of review depending on whether the director decision in question deals with an "enterprise" issue, such as whether the company should expand, or an "ownership" issue, such as the negotiated price for a merger (roughly corresponding to the "change of control" situation discussed in text). "Ownership" issues receive higher scrutiny. See Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 473-74 (1992); Bayless Manning, *Reflections and Practical Tips for Life in the Boardroom After Van Gorkom*, 41 BUS. LAW. 1, 6 (1985); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 505 (1986).

134. For an essay fearing that *Anadarko* is symptomatic of a general decline in the law's willingness to make actors do the right thing, see Lawrence E. Mitchell, *A Parable of the 1980s: Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 53 ALB. L. REV. 655 (1989).

135. *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171, 1174 (Del. 1988).

owe a duty only to the parent-shareholder, and the parent-shareholder, in turn, does not owe a duty to the subsidiary corporation, what becomes of the directors' fiduciary duty to the subsidiary corporation and to the third parties that are sometimes beneficiaries of directors' duties?

There are at least two possibilities to explain the fate of the subsidiary directors' duty to the corporation and other constituencies. The first possibility is that duties to nonshareholders do not exist in the wholly owned subsidiary context. This conclusion must be wrong, or else shareholders could cut off any fiduciary duty to third parties merely by placing all their operating companies in the ownership of a holding company.

The second possibility is that the board of directors of the holding company bears a duty to the "corporation" it directs, and that corporation is defined to include the wholly owned subsidiaries. This approach seems workable, but case law supporting it is hard to find. In this view, the duties of the subsidiary directors would be imposed on the parent.

Although no cases involving these conflicts in the wholly owned subsidiary context exist, cases involving subsidiaries with minority shareholders shed some light on the matter. In these minority shareholder subsidiary cases, the disputes usually turn on the question whether the majority shareholder has taken a benefit from the subsidiary at the expense of the minority interest.¹³⁶ In dicta, the courts have provided some guidance for subsidiary directors in resolving the conflict of duties between the parent-shareholder and the subsidiary as corporate entity.

Unfortunately, the guidance is often unhelpful. For example, in *Jones v. H.F. Ahmanson*,¹³⁷ the California Supreme Court made the enigmatic statement that "the fiduciary obligations of directors and

136. See *infra* notes 222-231 and accompanying text.

137. 460 P.2d 464 (Cal. 1969). The case involved a savings and loan that was 85% owned by a group of shareholders acting in concert and 15% owned by minority shareholders. *Id.* at 467. The market for S&L's in California at the time was very bullish and the majority wanted to find a way to cash in on the popularity of S&L stocks by somehow creating a market for their shares. *Id.* Instead of voting a stock split in the S&L's stock and directly accessing the securities market with the S&L as the issuer, the majority instead decided to form a holding company that would own their 85% interest. The holding company, in turn, would access the securities market and thereby create a market for the majority's ownership interest in the S&L. Of course, this strategy left the 15% minority shareholders in the S&L without a market for their shares and no way to cash out except to sell to the holding company at a discount. The minority sued the majority for breach of its fiduciary duty.

shareholders are neither limited to specific statutory duties and avoidance of fraudulent practices nor are they owed solely to the corporation to the exclusion of other shareholders."¹³⁸ This intriguing passage is anything but a model of clarity. While it is clear that the court sees a duty to the shareholders, it is not clear what it means by the term "corporation." Because the court notes a duty to "other shareholders," perhaps "corporation" is being used as a shorthand way to refer to only the "majority shareholders."¹³⁹

On the other hand, the quotation comes after a discussion of *Remillard Brick Co. v. Remillard-Dandini*,¹⁴⁰ which quoted *Pepper v. Litton*¹⁴¹ at great length. The *Pepper* case concerned the rights of creditors to have priority in bankruptcy over the claims of insiders, and clearly established the director's duty to the "entire community of interests in the corporation"¹⁴²—not just to the shareholders. While *Pepper* acknowledged a duty to the corporation and viewed the concept of the corporation quite broadly, it does not appear that the *Ahmanson* court meant the term "corporation" to be used in that sense. The *Ahmanson* court's statement that the controlling shareholder's use of its power "must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business"¹⁴³ reinforces the notion that directors owe a duty to the shareholders as a whole, but without establishing what kind of duty, if any, is owed to the corporation as an entity.

Nevertheless, the admonition not to take action that will "conflict with the proper conduct of the corporation's business," read in light of the favorable citation to *Pepper*, may amount to a broadly-defined duty to the "corporation." In fact, the opinion quotes *Pepper* for the proposition that directors bear the burden "not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."¹⁴⁴ A later

138. *Id.* at 472 (citing *Remillard Brick Co. v. Remillard-Dandini*, 241 P.2d 66 (Cal. Dist. Ct. App. 1952)).

139. The *Ahmanson* opinion does cite an old case that appears to use the term in that manner: "When a number of stockholders combine to constitute themselves a majority in order to control the corporation as they see fit, they become for all practical purposes the corporation itself, and assume the trust relation occupied by the corporation towards its stockholders." 460 P.2d at 473 (quoting *Ervin v. Oregon Ry. & Nav. Co.*, 27 F. 625, 631 (C.C.S.D.N.Y. 1886)).

140. 241 P.2d 66, 75 (Cal. Dist. Ct. App. 1952).

141. 308 U.S. 295 (1939).

142. *Id.* at 307; see *supra* notes 83-84 and accompanying text.

143. 460 P.2d at 471.

144. *Id.* (emphasis added) (quoting *Pepper v. Litton*, 308 U.S. 295, 306 (1939)).

California case, *Smith v. Tele-Communication, Inc.*,¹⁴⁵ reiterates this language,¹⁴⁶ but does not elaborate on what the cases mean by "corporation." Perhaps significantly, the *Smith* case omits from the phrase "and those interested therein" from the original quotation.¹⁴⁷ The opinion gives no indication whether the change is intentional, and if so, whether it is important. In the end, it remains hard to tell who the recipient of the subsidiary directors' duties should be.

C. Appreciating the Significance of the Subsidiary Director's Dilemma

The concern over subsidiary director liability to nonshareholders is not a purely academic enterprise. For example, in many cases the directors of subsidiary banks have found themselves subject to liability to the FDIC. The chain of events leading to liability begins when a bank fails and the FDIC is appointed as receiver. As receiver, the FDIC must maximize the value of assets owned by the failed bank, including any causes of action the bank may have. Therefore, the FDIC may bring claims on behalf of the failed bank against the bank's directors for failure to take action in the best interest of the bank.¹⁴⁸ In addition, bank directors are personally liable under federal banking laws.¹⁴⁹

The subsidiary directors are held personally liable despite the fact that banking law contains the seeds of enterprise liability.¹⁵⁰ The banking regulatory scheme employs enterprise principles when it

145. 184 Cal. Rptr. 571 (Ct. App. 1982).

146. *Id.* at 575.

147. *Id.*

148. Barnett, *supra* note 18, at 72-74 (describing actions); *id.* at 103-19 (providing examples of FDIC complaints). Making life even more difficult for bank directors is the "adverse domination" doctrine, which can prevent the statute of limitations from tolling on causes of action against the board of directors. See Michael E. Baughman, Comment, *Defining the Boundaries of the Adverse Domination Doctrine: Is There Any Repose for Corporate Directors?*, 143 U. PA. L. REV. 1065 (1995).

149. See 12 U.S.C. § 1821(k) (1994); Douglas V. Austin & Sidney M. Weinstein, *Bank Officer and Director Liability Under FIRREA: The Need for a National Standard of Gross Negligence*, 111 BANKING L.J. 67 (1994); Cindy A. Schipani, *Should Bank Directors Fear FIRREA: The FDIC's Enforcement of the Financial Institutions Reform, Recovery and Enforcement Act*, 17 J. CORP. L. 739 (1992); Jon Shepherd, Note, *The Liability of Officers and Directors Under the Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 90 MICH. L. REV. 1119 (1992).

150. BLUMBERG & STRASSER, STATUTORY LAW: SPECIFIC, *supra* note 75, at 992-94; Sommer, *supra* note 5, at 229 (observing that "the banking industry utilizes legal devices that apparently confer legal personality on the subsidiary without conferring limited liability on the parent").

seeks to impose liability on bank holding companies¹⁵¹ at every opportunity.¹⁵² Nevertheless, regulators continue to cling to the idea that bank holding companies and their subsidiaries are independent corporations.¹⁵³

Banking law's use of the independent corporation model places bank directors in an awkward position. The vast majority of banks are owned by bank holding companies.¹⁵⁴ The subsidiary banks, in turn, are governed by boards of directors. Although banking regulators use corporate enterprise principles to reach the resources of bank holding companies, they employ independent entity principles to hold directors of subsidiaries personally liable. Perhaps this seeming contradiction is a means to recover from as many parties as possible in a given situation. Alternatively, perhaps regulators sincerely believe that subsidiary directors may act independently and therefore should be held

151. As defined by statute, a bank holding company is any company that has control over a bank or over a company that is or becomes a bank holding company. 12 U.S.C. § 1841(a)(1) (1994). Typically bank holding companies are corporations. *But see* 12 U.S.C. § 1841(b) (1994) (defining bank holding company to mean any "corporation, partnership, business trust, association, or similar organization"). The bank holding company itself is merely a regular corporation formed under state incorporation laws. Although bank holding companies do not require special charters, they are regulated by the Federal Reserve Board under the Bank Holding Company Act. 12 U.S.C. §§ 1841-1850 (1994).

152. Methods employed by banking regulators to impose liability on bank holding companies include, among other things, the so-called source of strength doctrine, 12 C.F.R. § 225.4(a) (1995), cross guarantee provisions, 12 U.S.C. § 1815(e) (1994), and capital restoration plans, 12 U.S.C. § 1831o(e)(2)(C)(ii) (1994).

153. The attempt to suggest that banking is really designed to be an enterprise liability situation rings hollow in light of the requirements that banks and securities affiliates have separate boards, that banks in separate states have separate boards, and that affiliates within a bank holding company adhere to other "firewalls" designed to keep the holding company subsidiaries as "independent" as possible. *See, e.g.*, Citicorp, New York, New York, Order Approving the Acquisition of Savings and Loan Association, Fed. Res. Bull. 656, 659-60 (Oct. 1982) (conditioning regulatory approval of acquisition on, among other things, operation of the new subsidiary as a "separate, independent, profit-oriented corporate entity").

154. In 1988, a total of 6,503 bank holding companies owned 9,322 domestic commercial banks, representing 84.6% of the total number of domestic commercial banks and 90.2% of the bank deposits in the country. Steven B. Long, Note, *AMBAC: The Substantial Question Doctrine Under the Bank Holding Company Act*, 79 GEO. L. J. 507, 507 n.1 (1991) (citing CONFERENCE OF STATE BANK SUPERVISORS, A PROFILE OF STATE-CHARTERED BANKING 225 (1988)). The predominance of the bank holding company structure can be attributed to various historical, economic and political forces. Bank holding companies can be seen as a marketplace response to the restrictive laws affecting the banking industry. Although banks were restricted as to the kinds of businesses they could engage in and where they could branch, bank holding companies did not face those restrictions, and provided an effective way to avoid the constraints of the banking laws. *See* JONATHAN R. MACEY AND GEOFFREY P. MILLER, *BANKING LAW AND REGULATION* 293-96 (1992).

personally accountable for their acts. However, despite regulators' hopes and desires, in the real world, directors of subsidiary banks frequently lack the expertise and access to information necessary to make sophisticated banking decisions or to critically analyze actions proposed by the holding company.¹⁵⁵ While the ideal of truly independent directors is a wonderful aspiration, in the real world directors' attempts at disinterested decision-making are often hobbled by management. Holding such directors personally liable for decisions they had little control over is unfair. A fairer result would be for regulators to treat the whole bank holding company as one enterprise and not focus on the directors of specific subsidiary banks.

The unfairness stems from the inappropriate application of the independent entity model to the subsidiary corporation. The idea of subsidiaries as independent legal persons is tied up in antiquated nineteenth-century ideas about corporate personality.¹⁵⁶ Indeed, the idea of parent and subsidiary as independent entities is central to the primary reason for forming subsidiaries—limitation of the parent's liability.¹⁵⁷ In recent years a great deal has been written about the pros and cons of limited liability in the corporate context;¹⁵⁸ however, very little

155. Hawke, *supra* note 19; Bayless Manning, *The Business Judgment Rule and the Director's Duty of Attention: Time for Reality*, 39 BUS. LAW. 1477, 1481-92 (1984). As the American Bar Association's Committee on Corporate Laws has pointed out, unaffiliated directors of controlled corporations frequently face "practical difficulties" in fulfilling the review function, especially because of lack of access to relevant information. Committee on Corporate Laws, American Bar Association, *Guidelines for the Unaffiliated Director of the Controlled Corporation*, 44 BUS. LAW. 211, 212-13 (1988).

156. There have been several excellent treatments of corporate theory that examine the evolution of the idea of the corporation from a concession granted by the sovereign to an artificiam person to a natural person to an aggregate of contractual interests. For general background on this topic, see HERBERT HOVENKAMP, *ENTERPRISE AND AMERICAN LAW 1836-1937*, at 12 (1991); JAMES W. HURST, *THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 1780-1970*, at 4 (1970); Phillip I. Blumberg, *The Corporate Entity in an Era of Multinational Corporations*, 15 DEL. J. CORP. L. 283 (1990); Morton J. Horwitz, *Santa Clara Revisited: The Development of Corporate Theory*, 88 W. VA. L. REV. 173 (1985); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201.

157. See CHESTER ROHLICH, *ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES* § 10.02 (5th ed. 1975).

158. Easterbrook & Fischel, *supra* note 5, at 52; Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879 (1991) (suggesting an alternative regime to traditional limited liability); Janet Cooper Alexander, *Unlimited Shareholder Liability Through a Procedural Lens*, 106 HARV. L. REV. 387 (1992) (pointing out procedural obstacles to the Hansmann and Kraakman approach); Joseph A. Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387 (1992) (pointing out various dynamics present in the capital markets that would develop and likely frustrate the Hansmann and Kraakman approach); Larry E. Ribstein, *Limited Liability and Theories of the Corporation*, 50 MD. L. REV. 80

of the scholarship applies directly to the special case of subsidiary corporations.¹⁵⁹ Professor Blumberg has concluded that many of the traditional theoretical factors justifying limited liability for corporations generally become irrelevant in the context of subsidiary corporations.¹⁶⁰ Others have argued that the limited liability aspect of the subsidiary is economically inefficient and therefore undesirable.¹⁶¹ Nevertheless, in modern practice, corporations form subsidiaries for many reasons besides the desire to limit liability, such as to comply with regulatory ownership requirements, or a desire to establish certain procedural benefits, such as venue and jurisdiction.¹⁶² Regardless of the reasons for the use of subsidiaries, they form a cohesive economic unit with their parent and related corporations.

In the modern world, where one corporate enterprise might act through hundreds of wholly owned subsidiaries across the country and around the world,¹⁶³ the fiction of separate corporate personality for each subsidiary in a corporate group does not reflect reality. Because there is little practical difference in the real world between a wholly

(1991) (examining and rejecting the idea that limited liability is a privilege granted by the state; finding instead that limited liability is the product of private ordering and thereby compels the acceptance of the contract theory of the corporation); Richard A. Booth, *Limited Liability and the Efficient Allocation of Resources*, 89 Nw. U. L. REV. 140 (1994) (viewing the primary purpose of limited liability to be the elimination of barriers between corporations and their creditors).

159. Exceptions include Easterbrook & Fischel, *supra* note 5, at 110-11, Posner, *The Rights of Creditors*, *supra* note 5, at 509-16, and of course BLUMBERG, *supra* note 5. Professor Blumberg has summarized the various advantages of limited liability as follows: permitting absentee investors to avoid exposure to risk; permitting large-scale enterprise; permitting diversification of portfolios; avoiding increased agency costs; avoiding impairment of the efficiency of the capital market; avoiding increased collection costs for creditors; avoiding the costs of contracting around liability; and the encouragement of risk-taking. The disadvantages of limited liability generally are: unfairness and inefficiency for tort and other involuntary creditors; unfairness and inefficiency for labor claimants; the encouragement of excessive risk taking; increased information and monitoring costs; impairment of the efficiency of the market; and the possibility of misrepresentation. BLUMBERG, *SUBSTANTIVE LAW*, *supra* note 2, §§ 4.021-4.046; *see also* Easterbrook & Fischel, *supra* note 5, at 40-62.

160. BLUMBERG, *SUBSTANTIVE LAW*, *supra* note 2, § 5.01.

161. Sommer, *supra* note 5, at 231-42.

162. *See* ROHLICH, *supra* note 157 (citing various legal reasons for subsidiary formation such as to limit liability, to avoid restrictions in the parent's charter or restrictions arising under law, for tax reasons and for purposes of avoiding complications arising from "foreign corporation" status; also citing nonlegal reasons such as increasing the morale of the subsidiary's management, to settle shareholder disputes and public relations purposes); LARRY A. SODERQUIST & A.A. SOMMER, JR., *UNDERSTANDING CORPORATE LAW* 238-41 (1990) (citing use of subsidiaries in corporate acquisitions); Sommer, *supra* note 5, at 259-73 (citing use as an effective method for controlling choice of law and venue).

163. Hadden, *Inside Corporate Groups*, 12 INT'L J. SOC. L. 271, 274 (1984).

owned subsidiary and a traditional corporate division, it seems unfair that the legal treatment of one should differ from the other.¹⁶⁴ Not only does the independent entity model of the corporation fail to reflect reality, it also presents an obstacle to clear thought on how corporate groups should be treated under the law.¹⁶⁵ To deal effectively with the legal issues of subsidiaries and complex corporate groups, the law must break out of traditional paradigms of corporate personality and embrace an idea of a corporate enterprise that cuts across particular legal entities.¹⁶⁶

The United States Supreme Court may be moving in the direction of adopting such corporate enterprise principles. The high court has historically recognized corporations as "artificial beings."¹⁶⁷ The Court has ruled that, as legal persons, corporations are entitled to many of the same constitutional rights as natural persons.¹⁶⁸ At the same time, however, the Court has refused to recognize subsidiary corporations as entities independent of their shareholder parent. In

164. EISENBERG, *supra* note 1, at 303. For a traditional view of the rather inconsequential managerial aspects of the subsidiary-division distinction, see Robert W. Murphy, *Corporate Divisions vs. Subsidiaries*, 34 HARV. BUS. REV. 83 (Nov.-Dec. 1956).

165. Legal thinking tends to become trapped in traditional paradigms. As Professor Latty put it so eloquently almost sixty years ago: "The defects of the intransigent conceptualism which apparently accompanies the entity technique is of itself a source of danger in legal thinking." ELVIN R. LATTY, *SUBSIDIARIES AND AFFILIATED CORPORATIONS* 27 (1936).

166. Professor Adolph Berle advanced this idea almost fifty years ago: "In effect what happens is that the court, for sufficient reason, has determined that though there are two or more personalities, there is but one enterprise; and that this enterprise has been so handled that it should respond, as a whole, for the debts of certain component elements of it." Adolph Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 350 (1947). The idea of enterprise liability has been developed extensively by Professor Blumberg in his treatise, *THE LAW OF CORPORATE GROUPS*, and in various articles, see, e.g., *supra* note 156.

167. *Trustees of Dartmouth College v. Woodward*, 17 U.S. (4 Wheat.) 518, 636 (1819). For an excellent discussion of the constitutional aspects of corporate personality, see BLUMBERG, *SUBSTANTIVE LAW*, *supra* note 2, at 299-318.

168. As Justice O'Connor conveniently summarized:

[A] corporation has a First Amendment right to freedom of speech, *Virginia Pharmacy Bd. v. Virginia Citizens Consumer Council, Inc.*, 425 U.S. 748 (1976), and cannot have its property taken without just compensation, *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978). A corporation is also protected from unreasonable searches and seizures, *Marshall v. Barlow's, Inc.*, 436 U.S. 307 (1978), and can plead former jeopardy as a bar to a prosecution, *United States v. Martin Linen Supply Co.*, 430 U.S. 564 (1977). Furthermore, a corporation is entitled to due process, *Helicopteros Nacionales de Colombia v. Hall*, 466 U.S. 408 (1984), and equal protection, *Metropolitan Life Ins. Co. v. Ward*, 470 U.S. 869 (1985), of law.

Browning-Ferris Indus., Inc. v. Kelco Disposal, Inc., 492 U.S. 257, 284-85 (1989) (O'Connor, J., concurring in part and dissenting in part).

Copperweld Corp. v. Independence Tube Corp.,¹⁶⁹ the Supreme Court struck down the "intra-enterprise conspiracy" doctrine of antitrust law.¹⁷⁰ The Court found that a parent corporation and its wholly owned subsidiary "are incapable of conspiring with each other"¹⁷¹ because, "a parent and a wholly owned subsidiary *always* have a 'unity of purpose or a common design.'"¹⁷² Therefore, although the Supreme Court recognized corporations generally as distinct legal persons in *Copperweld*, it recognized that subsidiary corporations are inextricably tied to the parent and cannot act independently.¹⁷³

The Supreme Court's development of a model of corporate groups as essentially single enterprises organized as separate legal entities is a step toward accommodating the awkward position of the subsidiary director, and helps bring the law into line with the realities of the business world.¹⁷⁴ Recognition that subsidiaries are but another agency for the controlling shareholder would bring a great deal of common sense and reason to this area of the law. The next step in the development of the corporate enterprise model, recognizing that subsidiary directors are merely agents of the parent corporation, would not be a big step away from existing case law.¹⁷⁵ In order to deal with subsidiaries, the law must abandon the traditional view of parent and subsidiary corporations as independent corporate entities and acknowledge the overwhelming role that the shareholder-parent plays in the life of the subsidiary.

169. 467 U.S. 752 (1984).

170. The intra-enterprise conspiracy doctrine was a type of Sherman Act violation in which a parent corporation conspired with entities it controlled to restrain trade. *Id.* at 759.

171. *Id.* at 777.

172. *Id.* at 771.

173. *Id.* at 771-72. The holding of *Copperweld* appears to extend an earlier Supreme Court case, *NLRB v. Deena Artware, Inc.*, 361 U.S. 398 (1960), in which the Court approved of the NLRB's view of affiliated corporations as a "single enterprise," where a parent so controlled its subsidiaries as to give rise to a principal-agent relationship. *Id.* at 402-04. It is also in accord with cases treating parent and subsidiary corporations as one party in interest for procedural purposes in litigation on the theory that, although conducted under separate legal entities, the corporations are all part of the same "integrated enterprise." See, e.g., *California Zinc Co. v. United States*, 72 F. Supp. 591, 593 (Ct. Cl. 1947); *United States ex rel. TVA v. Powelson*, 118 F.2d 79, 89 (4th Cir. 1941), *rev'd on other grounds*, 319 U.S. 266 (1943).

174. BLUMBERG & STRASSER, *supra* note 75, § 32.02.

175. See *infra* notes 217-26 and accompanying text.

III. Resolving the Dilemma

The duties of the directors of wholly owned subsidiaries have not been articulated clearly in the law. In part, this lack of clarity can be attributed to a lack of legal precedent, which, in turn, can be attributed to the fact that a parent corporation is unlikely to sue the board of its wholly owned subsidiary. Such litigation is only a remote possibility, since most subsidiary boards lack the independence necessary to pursue a course of action to which the parent might object. Even if a board were to possess such independence, it would also have to possess a lack of concern for personal liability. The thrill of exploring the outer limits of its fiduciary duties to the subsidiary would have to be balanced against the possibility of personal liability to the parent for breach of fiduciary duty.

Nevertheless, the lack of law on this subject does not mean that directors of wholly owned subsidiaries need no guidance. On the contrary, the lack of guiding precedent or statute makes the need for academic commentary all the more pressing. Academic commentary suggesting various possible schemes for resolving the subsidiary director's dilemma may provide needed guidance for directors and courts considering these matters. An ideal scheme would embody the principle of fairness, in that it would (1) treat similarly-situated actors in a similar manner; (2) afford actors a legitimate opportunity to comply with the law; (3) be simple, clear, and not subject to complicated special cases; (4) be efficient, in the sense that it would be neither redundant nor complicated to comply with; and (5) be predictable, so that those covered by the rule would be able to plan effective compliance.¹⁷⁶

Four approaches present themselves as possible solutions to the awkward problem of subsidiary directors' fiduciary duties: the traditional ad hoc approach, a contractarian approach, a modification of the "horizontal conflict" approach, and an approach I propose based on agency law.

(1) *Ad Hoc Approach*

Proponents of the "ad hoc" approach to fiduciary duties believe that spelling out a specific rule for the fiduciary relationship that will

176. Gregg A. Esenwein, *An Overview of the Issues Concerning a Flat-Rate Income Tax*, 15 TAX NOTES 947, 948-49 (1982).

cover every situation is a hopeless task.¹⁷⁷ Traditionally, the fiduciary duty acts as a protection for beneficiaries who are dependent on the actions and discretion of fiduciaries.¹⁷⁸ Although certain types of relationships are classically identified as "fiduciary" relationships,¹⁷⁹ the fiduciary's precise obligation depends on the context of the relationship.¹⁸⁰ The ad hoc approach to determining what duties the directors of a subsidiary owe to whom is probably the state of the law today: The facts and circumstances of the transaction in question determine the nature and extent of the duty owed.¹⁸¹ The ad hoc approach seems to be the method employed to determine what kind of duty the majority shareholder owes to minority shareholders in a subsidiary.¹⁸² In this situation-specific approach to the fiduciary duty, subsidiary directors may owe a duty to the parent shareholder only, or in other situations they may owe a duty to other constituents.¹⁸³

The case-by-case ad hoc approach is the central thesis of Professor Blumberg's treatise on parent and subsidiary corporations, *The Law of Corporate Groups*.¹⁸⁴ Believing that wholesale implementation of an enterprise principle for all corporate groups would not be realistic, Professor Blumberg recognizes that, in the absence of deter-

177. DeMott, *supra* note 132, at 879 ("Recognition that the law of fiduciary obligation is situation-specific should be the starting point for any further analysis.").

178. William W. Bratton, *Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law*, 61 GEO. WASH. L. REV. 1084, 1100-01 (1993); DeMott, *supra* note 132, at 915.

179. Such relationships include attorney-client, agent-principal, guardian-ward and trustee-beneficiary. See DeMott, *supra* note 132, at 908; *United States v. Chestman*, 947 F.2d 551, 568 (2d Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992).

180. DeMott, *supra* note 132, at 908.

181. See, e.g., *Smith v. Tele-Communication, Inc.*, 184 Cal. Rptr. 571, 574 (Ct. App. 1982) (when "overreaching" by parent is present, majority shareholder held to higher standard of fairness); *Palley v. McDonnell Co.*, 295 A.2d 762, 765 (Del. Ch. 1972) (transactions accomplished without the participation of the subsidiary's minority stockholders places controlling shareholder within the strictures of the rule of intrinsic fairness), *aff'd*, 310 A.2d 635 (Del. 1973); *Warren v. Century Bankcorp.*, 741 P.2d 846, 848-49 (Okla. 1987) (when parent exercises control so as to receive benefits not shared with the subsidiary's minority shareholders, the intrinsic fairness test applies).

182. See *Gabelli & Co. Profit Sharing Plan v. Liggett Group, Inc.*, 444 A.2d 261, 264-65 (Del. Ch. 1982) ("The mere existence of this [majority-minority shareholder] relationship, however, does not by itself invoke the intrinsic fairness test. The fiduciary relationship must be accompanied by a showing of self-dealing or some other disabling factor before the stricter test is warranted."), *aff'd*, 479 A.2d 276 (Del. 1984); see also 3 WILLIAM M. FLETCHER, *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 852 n.3 (perm. ed. rev. vol. 1986) (stating that the nature and extent of the fiduciary duty of the majority shareholders of a parent corporation to the minority shareholders of a subsidiary corporation depends on the facts and circumstances of each case).

183. Cf. DeMott, *supra* note 132, at 915.

184. BLUMBERG & STRASSER, *supra* note 75, § 31.03.

minative legislation, judicial application of enterprise principles necessarily involves a multidimensional analysis on a case-by-case basis.¹⁸⁵

The ad hoc approach presents some real problems for corporate directors. First, similarly situated persons might be treated differently. Such a result is an inescapable byproduct of the factual determinations inherent in the ad hoc approach. Consequently, some directors will have a duty imposed, while others in very similar situations will not. Secondly, the approach is not simple. Requiring an ad hoc determination in every case could get complicated, as parties expend resources to distinguish or to analogize to previous situations. Third, the ad hoc approach is not efficient; it requires expenditure of resources in every instance to determine what duties are owed. Finally, the ad hoc approach presents an obstacle for planning because it is not predictable. As anyone engaged in planning knows, the legally significant events that turn on "facts and circumstances" determinations are cause for lost sleep. Although the occasional precedent that is on all fours with the case before the court presents itself, such situations are few and far between. More likely the planner just crosses her fingers and hopes the determination comes out right. For these reasons, the ad hoc approach does not work well in the parent-subsidary context.

(2) *Contractarian Approach*

A great deal has been written about the "contractarian" model of corporate law, in which corporate statutes are seen as a kind of form contract that contracting parties can vary by agreement.¹⁸⁶ Under this view, corporate law should serve as a "default" term only—that is, it should apply only when the contracting parties have not agreed other-

185. Blumberg, *The Corporate Entity*, *supra* note 156, at 371. Among other factors, the extent that the parent exerts control over the subsidiary would be very important in deciding whether to allow recovery against the parent.

186. The literature on this topic is overwhelming and beyond the scope of this article. See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-39 (1991); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON U. L. REV. 99 (1989); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983); Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327 (1979); Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). For critique of the contractual theory, see William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989) [hereinafter Bratton, *The New Economic Theory of the Firm*]; William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989) [hereinafter Bratton, *The "Nexus of Contracts" Corporation*]; Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697 (1990).

wise.¹⁸⁷ When the law does provide a default term, contractarian theory holds that the law should supply the term that the parties would have agreed to had they bargained about the matter, or alternatively the law should employ the operational assumption of successful firms.¹⁸⁸ In the contractarian's world of freely bargaining parties, the market will lead to an economically efficient allocation of resources.¹⁸⁹

Under the contractual theory, the fiduciary duties traditionally borne by agents are treated like any other contractual term.¹⁹⁰ They can be bargained over and "opted out" of by the contracting parties.¹⁹¹ In this view, directors are mere agents of the shareholders and the law should provide rules that will minimize shareholder agency costs.

The *QVC* decision apparently rests on this theoretical foundation. The opinion appears to operate on the conception that a corporation is not so much a legal person in its own right as it is a collection of shareholders. For example, the *QVC* court stated that a valuable asset, the "control premium," belonged not to "a single person, entity, or group, but . . . [to a] fluid aggregation of unaffiliated stockholders."¹⁹² This perspective is consistent with the contractarian theory of corporations, in which the corporation is seen not as a legal "person," but rather as the intersection of a vast interconnecting web of con-

187. EASTERBROOK & FISCHEL, *supra* note 186, at 36.

188. *Id.* at 36, 245.

189. See Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418-19 (1989) (the dynamics of the market work in such a way as to make managers act as if they had investors' interests at heart, "almost as if there were an invisible hand"). But see Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757, 759-61 (1995) (questioning the contractarian paradigm on the ground that each individual contract in the nexus effects the value of other contracts and undermines the atomistic universe assumed by the contractarians); Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89 COLUM. L. REV. 1449, 1453-57 (1989) (discussing the shortcoming of the contract metaphor and noting that transaction costs and imperfect information prevent the formation of "ideal" contracts).

190. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 436 (7th Cir. 1987) (describing a fiduciary duty as "a standby or off-the-rack guess about what parties would agree to if they dickered about the subject explicitly"), *cert. dismissed*, 485 U.S. 901 (1988).

191. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 29-30 (1990); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 426-27 (1993); Jason Scott Johnston, *Opting In and Opting Out: Bargaining For Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291, 312 (1992).

192. *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 43 (Del. 1993) (emphasis added).

tracts between various constituencies. The court's rationale for imposing a higher duty on directors in the change-in-control context was that the shareholders were not able otherwise to fulfill their role as overseers of the management in that situation.¹⁹³

Some commentators see the contractarian approach to fiduciary duty as wrong-headed. As Professor DeMott has pointed out, our concept of fiduciary duty serves a more complex role than a mere contractual gap-filler.¹⁹⁴ As she notes, in many situations, fiduciary duties arise even in the absence of express contractual agreements or even when express contractual agreements have been breached.¹⁹⁵ Traditionally, unlike antitrust law, fiduciary law is a means for regulating relationships when one party is dependent on another party to take discretionary action in the best interests of the first party. Unlike the world of contract, traditional fiduciary law does not assume that all actors should be free to pursue their self-interest; fiduciary law seeks to prevent exactly that result.¹⁹⁶

Others have argued that although the idea of corporate law as a form contract is a useful metaphor, corporate law itself is not infinitely manipulable, but in fact has some mandatory terms.¹⁹⁷ The fiduciary duty of directors may be one of those mandatory terms.¹⁹⁸ The contractarians have countered that these mandatory terms are "trivial" because they fall into one of four categories: (1) they would have been universally adopted anyway; (2) they can be avoided by strategic planning; (3) they are changeable through the political process; or (4) they are unimportant.¹⁹⁹

193. *Id.* at 43. This aspect is consistent with a "nexus of contracts" view of the world, in which shareholders act as risk bearers and also assume the responsibility to police management and bear agency costs. The creation of fiduciary duties is one way to force directors to conform their conduct to the benefit of the shareholders. See EASTERBROOK & FISCHER, *supra* note 186, at 90-93.

194. DeMott, *supra* note 132, at 885-88.

195. *Id.*

196. Bratton, *supra* note 178, at 1101.

197. Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1396-99 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985).

198. The A.L.I. Principles of Corporate Governance consider the fiduciary responsibilities of directors to be mandatory and does not permit individual directors and their corporations to negotiate lower standards. A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 7.

199. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 544 (1990).

Finally, others have argued that while the "contract" approach must be understood primarily as a metaphor,²⁰⁰ a review of contract law provides legitimate grounds for criticism of the contractarian perspective. Most importantly, contractarians place a great deal of faith in the ability of freely contracting parties to reach economically efficient positions. Yet the complete freedom of contract embraced by contractarians is largely lacking in conventional contract law. As a substantive matter, contract law is not a matter of "anything goes," but has many regulatory aspects meant to prevent unfair results, especially when there are disparities in bargaining power.²⁰¹

As an approach to the subsidiary director problem, the contractarian model falls short of the ideals of fairness, simplicity, efficiency, and predictability. First, a rule that courts should impose the term that the parties would have negotiated if they had thought about the matter may result in similarly situated persons being treated differently. Different parties will have different subjective preferences, and the degree of duty will vary from one subsidiary to the next. Since the contractarian approach only includes shareholders and managers as the contracting parties, it ignores other parties to which duties may be owed.²⁰² Courts that take a broader view of what groups should be included in the nexus of contracts will reach results inconsistent with courts adhering to the shareholder-only model. If a court instead employs the version of the contractarian model that calls for using the term that successful firms have employed, inconsistent results will also occur as courts reach different conclusions about what terms "successful" firms employ. It is likely that, in parent-subsidiary relationships, that term used is one that favors the shareholder and disregards all other constituents.

Secondly, the contract approach is not simple. Inquiring into what contracting parties would have done is always speculative, and could get exceptionally complicated in corporations with several classes of securities and other legitimate contracting parties. Even if

200. Bratton, *The "Nexus of Contracts" Corporation*, *supra* note 186, at 410; Braucher, *supra* note 186, at 698.

201. Braucher, *supra* note 186, at 712-38 (discussing how contract law protects certain parties and otherwise pursues a regulatory role, wholly removed from considerations of economic efficiency, through the validity of consent, the interpretation of contracts and the supplying of missing terms).

202. Macey, *supra* note 70, at 173.

the "successful firm" approach is used, the court must still expend considerable effort to investigate what those firms do.²⁰³

Third, the contractarian approach is not efficient because it requires expenditure of resources in every instance to determine what the parties would have agreed to or what successful firms in fact do. Although the hypothetical bargain mechanism may lower the transaction costs of resolving a dispute,²⁰⁴ those transaction costs will still be present and could be large.

Finally, the contractarian approach presents an obstacle for planning because it is not predictable. Who knows what the parties would have agreed to? Often parties avoid issues in contract negotiations precisely because they cannot agree on specific terms and hope the issue will either not come up or will be resolved in their favor by a court. Perhaps the contractarian approach is actually a benefit for planners, since it places an added incentive on them to spell out all terms. But spelling out all terms, as the contractarians admit, is an almost impossible task,²⁰⁵ and that complexity is their primary reason for having fiduciary duties.

(3) "Horizontal Conflict" Approach

The quandary of subsidiary directors is a perfect example of what Prof. Lawrence Mitchell calls a "horizontal conflict"—a conflict in which the board has conflicting duties to different corporate constituencies.²⁰⁶ Horizontal conflicts are common in corporate law but are poorly understood and little analyzed. For example, directors owe

203. The power given to the court to determine what the parties would have done is a formidable power, even though it is a task courts undertake all the time. See Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865, 893 (1990) (noting that the courts' power to supply the missing terms is "an awesome power indeed"). But see Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 GEO. L.J. 71, 108 n.193 (1989) (defending the hypothetical bargain approach because it minimizes transaction costs).

204. Ribstein, *supra* note 203, at 108 n.193.

205. Easterbrook & Fischel, *supra* note 191, at 426.

206. Mitchell, *supra* note 62, at 591. As Professor Mitchell explains:

These conflicts between virtually omnipotent managers and relatively powerless constituents of the corporation (or the corporation itself) can be described as "vertical conflicts of interest," since they exist between a powerful group and relatively powerless groups within the hierarchical corporate structure. . . . The exception to this unitary approach is the recent focus on conflicts *among* constituents, which has been sharpened by the dislocations caused by the takeover phenomenon. I term these conflicts, which exist among two or more relatively powerless groups that have interests in the corporation, "horizontal conflicts."

Id.

shareholders a fiduciary duty, but what happens when there is more than one class of stock? Sometimes the directors must make decisions that benefit one class more than another class, but the law has not dealt with these situations very satisfactorily.²⁰⁷ The incidence of horizontal conflicts multiplies when one recognizes the many duties that directors owe to constituents other than the shareholders.²⁰⁸

Professor Mitchell has suggested that subsidiary directors should be held to a standard similar that which directors of closely held corporations must meet under *Wilkes v. Springside Nursing Home, Inc.*²⁰⁹ In that case, a shareholder-employee of a closely-held corporation was fired from his job with the corporation after a falling-out with his fellow shareholders. The Massachusetts Supreme Judicial Court applied the fiduciary duty between close corporation shareholders that it first expounded in *Donahue v. Rudd Electrotrope*.²¹⁰ In holding for the injured shareholder, the Massachusetts court developed a test that actions harming a minority shareholder must be undertaken for a legitimate business purpose and may be challenged further by the injured shareholder if he can show that the corporate objective could have been achieved by a less injurious method.²¹¹

Although the directors would continue to act in the best interest of the shareholders, they would also be required to consider the effect of their action on a range of statutorily defined constituents.²¹² If they could prove injury, the constituents under Mitchell's scheme would have standing to sue the board. The board, in turn, would have the burden of showing that its action was taken in pursuit of a legitimate corporate purpose rather than for the benefit of the board itself.²¹³ If the board could demonstrate the legitimate purpose, then the plaintiffs would be allowed to prove that the board's goal could have been accomplished by less injurious means.²¹⁴

In an ideal world, this scheme might be the best way to proceed. Unfortunately, no cases or statutes have given standing to non-shareholder constituents to challenge board action.²¹⁵ But even if courts suddenly and uniformly embraced the Mitchell approach and

207. *Id.* at 638-39.

208. See *supra* notes 38-54, 82-115, and accompanying text.

209. 353 N.E.2d 657 (Mass. 1976).

210. 328 N.E.2d 505 (Mass. 1975).

211. *Wilkes*, 353 N.E.2d at 663.

212. Mitchell, *supra* note 62, at 635.

213. *Id.* at 636.

214. *Id.*

215. Mitchell himself concedes this point. *Id.* at 631.

found standing, the Mitchell approach would still not work in the subsidiary context. First, it would be unfair to subsidiary directors. The directors are subject to the control of the shareholder.²¹⁶ Attenuated constituent interests that may or may not be sufficiently demonstrated at trial pale by comparison to the omnipresent and dominant interest of the shareholder. The subsidiary directors are not free agents, but must do the bidding of the parent; it is unfair to expect them to meet larger obligations to nonshareholder constituents. Second, the approach is not as simple as it could be. The burden of proof bounces back and forth between parties; determining constituency harm and potentially less harmful alternatives are flexible standards that will not make sense from one case to the next. Third, the approach is inefficient because it wastes resources second-guessing the board. Finally, it is unlikely to be predictable because the board's actions will always be subject to review for a less harmful alternative.

(4) *Agency Approach*

In light of the dominant role played by the shareholder in the operation of the subsidiary, it seems disingenuous to pretend that directors act independently of the wishes of the parent.²¹⁷ The directors rarely will be able to carry out their duties in the horizontal conflict situation, nor will they be able to discharge their duty to some other constituency if the ad hoc approach finds a duty. The board is beholden to the dominant shareholder constituency and will act in accordance with the shareholder's wishes. Further inquiry in most cases would be a waste of time.

Given this reality, the law should treat subsidiary directors in accordance with their true status as agents of the parent and impose on them only the duty to act in the parent's best interests.²¹⁸ In turn, the duties that directors of subsidiary corporations would have had if they were truly independent should be imposed directly on the parent corporation. In this way agency principles could supplement traditional

216. Eisenberg, *supra* note 1, at 299-300.

217. The ABA Committee on Corporate Laws has tried to finesse the problem of controlled directors by stating that the duties of affiliated and unaffiliated directors are the same. Committee on Corporate Laws, *supra* note 155, at 213. Nevertheless, the Committee recognizes that, "[w]hile both affiliated and unaffiliated directors have the same fiduciary duty to the controlled corporation, the affiliated directors cannot be expected to be wholly detached from the special objectives of the controlling shareholder." *Id.* at 212.

218. This is the position taken by the Delaware Supreme Court in *Anadarko Petroleum Corp. v. Panhandle Eastern Corp.*, 545 A.2d 1171 (Del. 1988), and adopted as black-letter law in 3 FLETCHER, *supra* note 182, § 852 n.4.50 (Supp. 1994), citing only *Anadarko* for support.

entity law. We could continue to recognize the legal separateness of subsidiaries but also supplement that idea with the understanding that, as part of a corporate group, the duties of the directors should be passed on to the parent corporation.²¹⁹ As has been recognized in many cases in which the subsidiary has minority shareholders, the majority shareholder should be impressed with the duty of the directors.²²⁰ In the case of wholly owned corporations, that duty should be the duty to make decisions in the best interest of the *corporation*, not merely in the interests of the shareholders.

Of course, the agency idea is an ancient one.²²¹ But recent cases have applied it in the context of transactions involving "fair dealing" with minority shareholders.²²² This approach would amount to an enlargement of the cases dealing with the duties of controlling shareholders, such as *Sinclair v. Levien*,²²³ *Weinberger v. UOP*,²²⁴ *Burton v. Exxon*,²²⁵ and *Chiles v. Robertson*.²²⁶ In *Chiles*,²²⁷ for instance, the

219. Professor Blumberg has considered this idea in the context of liability for subsidiaries, although I focus here on the liabilities of the subsidiary directors as agents of the parent. See BLUMBERG, *SUBSTANTIVE LAW*, *supra* note 2, at 365-70.

220. See John C. Carter, *The Fiduciary Rights of Shareholders*, 29 WM. & MARY L. REV. 823, 841-42 (1988).

221. Justice Cardozo made reference to the agency idea in the tort context seventy years ago. *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926) ("Dominion may be so complete, interference so obtrusive, that by the general rules of agency the parent will be a principal and the subsidiary an agent. Where control is less than this, we are remitted to the tests of honesty and justice.") Justice Traynor of California cited an 1886 case that essentially impressed the majority shareholders with the fiduciary duties of the directors. See *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 473 (Cal. 1969) (citing *Ervin v. Oregon Ry. & Nav. Co.*, 27 F. 625, 631 (C.C.S.D.N.Y. 1886)).

222. See, e.g., *Jones v. H.F. Ahmanson & Co.*, 460 P.2d 464, 471 (Cal. 1969) ("Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority."); *infra* notes 217-26 and accompanying text.

223. 280 A.2d 717 (Del. 1971).

224. 457 A.2d 701, 703 (Del. 1983) (the majority shareholder bore the burden of proving by a preponderance of the evidence that the cash-out merger was fair); *accord* *Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 500 (Del. Ch. 1990).

225. 583 F. Supp. 405 (S.D.N.Y. 1984). The court recognized that parent corporations owe the minority shareholders of their subsidiary corporations a fiduciary duty. *Id.* at 414. The directors of the subsidiary placed there by the parent may be subject to the "intrinsic fairness" test to review self-dealing transactions in which the parent gets a benefit to the exclusion of the minority shareholder. *Id.* at 416.

226. 767 P.2d 903 (Or. Ct. App. 1989).

227. The facts of *Chiles* are exceptionally complicated, so I have taken some liberties with them here to present the essence of the situation. The plaintiff was a minority shareholder in several real estate corporations that had been set up to own shopping center properties and to lease those properties to stores of the Fred Meyer chain. The lease payments from Fred Meyer, Inc. to the real estate corporations were set so as to cover the mortgage payments on those properties. Because the leases were for a set amount and ran

court found that the directors of a group of subsidiaries who were dealing with their parent over issues involving a lease should have recognized their fiduciary duty to the minority shareholder of the subsidiaries and negotiated the best possible deal for the subsidiaries. The court properly imposed the duty of the subsidiary's directors directly on the controlling shareholder.²²⁸

In *Sinclair*, the Delaware Supreme Court recognized that "[a] parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings."²²⁹ Although the case arose in the context of a parent's self-dealing transactions, nothing in the opinion requires that the parent's fiduciary duty be limited to those situations. In fact, the case explicitly recognizes that when a shareholder dominates a corporation and the selection of the corporation's board of directors, the dominating shareholder should be charged with the duties ordinarily imposed on the directors.²³⁰ In that vein, *Sinclair* evaluated the parent's liability for certain parent-subsidiary transactions in light of the business judgment rule or the intrinsic fairness test—the same standards that would have applied to independent directors in the same position. The case seems logical and compelling; in the con-

for a long term, eventually the lease payments fell far below the market rental for similar commercial real estate. Of course, the low rent was a great economic benefit to Fred Meyer, Inc.

The controlling shareholder of Fred Meyer, Inc. was also the controlling shareholder in the real estate corporations. Eventually Fred Meyer, Inc. obtained ownership of the shares in the real estate corporations that had been owned by the controlling shareholder, so the real estate corporations became subsidiaries of Fred Meyer Inc. As a result of Fred Meyer, Inc.'s acquisition of those shares, it essentially became its own landlord, controlling the real estate corporations to which it paid rent.

In the early 1980s, the leveraged buy-out firm of Kohlberg Kravis and Roberts made a proposal to take Fred Meyer, Inc. private. In order to make the deal work, however, KKR needed to find a way to capture the value of the below-market-rate leases. Through clever structuring, KKR decided to spin off Fred Meyer, Inc.'s interest as lessee in the sweetheart leases to a limited partnership that would then sublease the stores to the "new" Fred Meyer, Inc., which would be owned by the buy-out group. By creating the limited partnership and the sublease, the new limited partners would obtain tax benefits which would improve the return on the buy-out. In order to substitute the "new" Fred Meyer, Inc. as tenant under the leases, the real estate corporations had to give their consent. When the real estate corporations controlled by Fred Meyer, Inc. rolled over and played dead instead of extracting some financial concessions in return for the consent, Chiles sued for breach of fiduciary duties to him as a minority shareholder of the subsidiary. *Id.* at 905-11.

228. 767 P.2d at 916.

229. 280 A.2d at 720; *accord* Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 888 (Del. 1970). *But see* *In re New York Rys.*, 82 F.2d 739, 741 (2d Cir. 1936) (where controlling shareholder did not also control the board of directors, "there is no basis for the contention that the [controlling shareholder] was in any fiduciary relationship"), *cert. denied*, 298 U.S. 687 (1936).

230. *Sinclair*, 280 A.2d at 719.

text of wholly owned subsidiaries, it establishes the rationale for imposing all the duties of the subsidiaries' directors on the parent, whether those duties run to minority shareholders, creditors, stakeholders or regulators.

Similarly, in *Wright v. Heizer Corp.*,²³¹ a majority shareholder who controlled the board of directors caused the board to enter into a pledge of the controlled corporation's assets to the controlling shareholder on terms that were unfair to the controlled corporation. In a derivative action by a minority shareholder, the controlling shareholder was found liable.²³² Cases of this type, in which the controlling corporation overreaches, generally end with the parent corporation owing a duty to the minority shareholders of the subsidiary. A logical extension of that doctrine, however, would require that the parent take on the duties that the subsidiary directors would have owed to any other constituencies as well.²³³

A recent case gets it right. In *Pioneer Annuity Life Insurance Co. v. National Equity Life Insurance Co.*,²³⁴ an Arizona Court of Appeals judge adopted the position that the parent corporation owed its subsidiary and "its cognizable communities of interest a fiduciary duty to act fairly."²³⁵ The case involved an insurance holding company which allegedly had systematically looted its subsidiary insurance company. When both parent and subsidiary landed in receivership after the parent's misapplication of reinsurance premiums, the subsidiary's receiver sued to impress a constructive trust on the reinsurance premiums paid by the subsidiary to the parent. In overturning a grant of summary judgment in favor of the parent, the Court of Appeals recognized that the fiduciary duty borne by the parent was owed to "policyholders and contractholders" of the subsidiary.²³⁶

An agency rule that presumptively holds the parent liable for all duties that the subsidiary directors should have discharged fulfills the practical goals of fairness, simplicity, efficiency, and predictability. On fairness grounds, the subsidiary directors are not caught in the Catch-22 that currently plagues them. Similarly situated directors will be treated the same—they will owe a duty to the parent, and the parent will pick up any other duties that should have been discharged.

231. 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978).

232. *Id.* at 251.

233. See *supra* notes 82-133 and accompanying text.

234. 765 P.2d 550 (Ariz. Ct. App. 1988).

235. *Id.* at 555.

236. *Id.*

Presumptively imposing shareholder liability on parent corporations may seem unfair to the parent and antithetical to the idea that the subsidiary is a separate legal entity. That objection can be answered in two ways. First, the idea of limited liability for shareholders is by no means ironclad. As late as 1900, the distinction between the liability of corporate shareholders and the liability of partners in a partnership was more a matter of degree than of kind.²³⁷ The relatively recent advent of limited shareholder liability is especially novel in the banking²³⁸ and insurance²³⁹ industries, which until recently imposed liability on shareholders in cases of economic failure. In modern times, courts still "pierce the corporate veil" when necessary to avoid an unjust result. Some commentators have suggested that this would make courts more willing to pierce the corporate veil of the subsidiary to reach the parent corporation;²⁴⁰ a recent empirical study of reported cases, however, does not support such a claim.²⁴¹ Certainly, when a corporation employs the subsidiary device as a way to avoid "a clear legislative purpose," the courts will disregard the separate existence of various corporate entities.²⁴²

237. Horwitz, *supra* note 156, at 208.

238. See Jonathan R. Macey & Geoffrey P. Miller, *Double Liability of Bank Shareholders: History and Implications*, 27 WAKE FOREST L. REV. 31, 31 (1992).

239. See DODD, *supra* note 28, at 304-05.

240. William P. Hackney & Tracey G. Benson, *Shareholder Liability for Inadequate Capital*, 43 U. PITT. L. REV. 837, 873 (1982); see also EASTERBROOK & FISCHER, *supra* note 186, at 56 ("Courts' greater willingness to allow creditors to reach the assets of corporate as opposed to personal shareholders is again consistent with economic principles."); Robert W. Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 992-94 (1971) ("courts are probably more willing to 'pierce the corporate veil' when the defendant is a corporation rather than an individual"); Jonathan M. Landers, *A Unified Approach to Parent, Subsidiary, and Affiliate Questions in Bankruptcy*, 42 U. CHI. L. REV. 589, 619 (1975) (a review of history suggests that the idea of limited corporate liability was never intended to shield parent corporations from obligations of subsidiary corporations).

241. Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036 (1991). The study actually found that of the 1,423 reported cases analyzed, courts were *less* likely to pierce the corporate veil of a subsidiary to reach the corporate parent than they were to pierce the veil of a corporation to reach a shareholder that is a natural person. *Id.* at 1056-57. Although the author of the study noted potential problems with the data sample that could skew the results, *id.* at 1045-46, he believes that those potential problems do not invalidate the sample or the usefulness of the data and the conclusions drawn therefrom, *id.* at 1046-47.

242. *First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba*, 462 U.S. 611, 629-30 (1983) ("the Court has consistently refused to give effect to the corporate form where it is interposed to defeat legislative policies"); *Schenley Distillers Corp. v. United States*, 326 U.S. 432, 437 (1946) ("corporate entities may be disregarded where they are made the implement for guiding a clear legislative purpose").

The second response is more compelling, however, because imposing the fiduciary duties of subsidiary directors directly on parent corporations does not involve "piercing the veil"—it is no more than an application of agency law. Subsidiary directors do not act independently in the best interest of the subsidiary corporation, but instead merely do the bidding of the parent who placed them in the director position. Finding the parent liable for the acts of its agents does not constitute piercing the veil and to characterize it as such misses the point.²⁴³

For simplicity, the agency rule has no peer. There is no *ad hoc* inquiry to undertake, no hypothetical bargain to construct, and no less harmful alternative to consider. Simply, the subsidiary directors are expected to do the parent's bidding and the parent pick is obliged to pick up any other duty that the subsidiary directors would have owed.

Additionally, the rule would be economically efficient because it would correct an externality existing in the current corporate structure. Currently, enterprises operated as corporate families enjoy too much limited liability from the duties owed to nonshareholder constituents. Consequently, the enterprise as a whole does not bear the full cost of its activities. As a result, these enterprises seem more profitable. These artificially profitable companies cause inefficient resource allocation by attracting more investment capital than they should.²⁴⁴ By imposing the fiduciary costs on the parent, this imbalance will be corrected.

Finally, such a rule will be predictable. When confronted with the duty of a subsidiary director, one will not have to engage in any judicial gymnastics, but will find instead a bright-line rule. Although bright line rules have a tendency to be blunt instruments incapable of handling special cases, they at least possess the virtue of being predictable.

Conclusion

Directors of subsidiaries find themselves in an untenable situation. They are frequently called upon to make decisions involving what Professor Mitchell has termed "horizontal conflicts." If, in resolving such a conflict, they make a decision that serves the interests of the subsidiary corporation as an entity or another legitimate corporate constituency at the expense of the shareholder, they risk losing

243. See Hamilton, *supra* note 240, at 983-84.

244. Booth, *supra* note 158, at 141.

their positions on the board and liability to the shareholder for breach of fiduciary duty. If they resolve the conflict by making a decision that favors the shareholder, they risk being held liable by regulators and other third parties to whom traditional corporate law may provide a fiduciary duty. If they resign their positions, some other actors step into the same quandary.

The idea of parent and subsidiary as separate corporate entities is a concept that has worked well in some situations for a long time. We must remind ourselves, however, that the idea of the corporation as a "person" and the idea of related corporations as "parent and child" are mere metaphors. Unlike real children, corporate subsidiaries usually do what the parent requests. The time has come for the law to face the reality of corporate life, relieve subsidiary directors from the charade of independence, and impose the duties that independent directors of subsidiaries should have borne directly on the parent corporation.

While the parent-child metaphor in corporate law may be helpful, it has its limits. As Justice Cardozo warned long ago, "[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it."²⁴⁵ We have reached the point where the metaphor of parent and subsidiary as independent corporate actors has lost its usefulness, and where holding companies should be held liable for the duties that subsidiary directors are charged with but are unable to carry out.

245. *Berkey v. Third Ave. Ry.*, 155 N.E. 58, 61 (N.Y. 1926).